No. _____

In The
Supreme Court of the United States

PHAR-MOR, INC.,
Petitioner,

v.

McKESSON CORPORATION,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

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January 23, 2009

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QUESTION PRESENTED

This Petition involves a question of commercial law, applicable to all fifty states pursuant to the Uniform Commercial Code, which has exceptional importance to banks and other financial institutions across the United States, impacting billions of dollars of loan transactions.

The question presented in this Petition is accordingly:

Whether the Sixth Circuit erred in concluding, contrary to the holdings of the Fifth Circuit and numerous federal courts in other circuits, that the Uniform Commercial Code permits an unpaid supplier, asserting a right to reclaim goods sold on credit, to strip a secured lender of its lien rights in those same goods?

PARTIES TO THE PROCEEDINGS AND RULE 29.6 STATEMENT

There are no parties to the proceedings other than those listed on the caption.

Pursuant to Supreme Court Rule 29.6, Petitioner states that it is not a subsidiary or affiliate of a publicly-owned corporation and that no publicly-traded corporation owns ten percent (10%) or more of its stock.

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SUMMARY OF PETITION

The Petitioner respectfully requests that a writ of *certiorari* be granted to review the Judgment and Opinion of the United States Court of Appeals for the Sixth Circuit entered in this case on July 17, 2008.

OPINIONS BELOW

The Opinion of the United States Court of Appeals for the Sixth Circuit, issued on July 17, 2008, is reported at 534 F.3d 502 (6th Cir. 2008) and has been included in the appendix at pages 1a-13a. The opinion of the United States District Court for the Northern District of Ohio, issued on October 6, 2005, has been included in the appendix at pages 14a-20a. The opinion and order of the United States Bankruptcy Court for the Northern District of Ohio in Youngstown issued on November 12, 2003, reported at 301 B.R. 482 (Bankr. N.D. Ohio 2003), and the Bankruptcy Court's amended orders entered on December 16, 2003 and December 18, 2003, have been included in the appendix at pages 21a-67a. The order of the United States Court of Appeals for the Sixth Circuit denying Petitioner's Request for Rehearing *En Banc*, issued on October 30, 2008 has been included in the appendix at pages 68a-69a.

STATEMENT OF JURISDICTION

The Judgment of the Court of Appeals for the Sixth Circuit was entered on July 17, 2008. A timely Request for Rehearing was denied on October 30, 2008. This Petition is timely filed according to Supreme Court Rules 13.1 and 13.3. The Court derives jurisdiction from 28 U.S.C. § 1254(1).

STATUTES AND REGULATIONS INVOLVED

This case involves Section 2-702 of the Uniform Commercial Code, set forth in Ohio Revised Code §1302.76, the provisions of which are reproduced in the appendix on page 70a.

STATEMENT OF THE FACTS

The Petitioner operated a national chain of deep-discount drug stores and filed for relief under Chapter 11 of the United States Bankruptcy Code on September 24, 2001 (the "Petition Date"). Several months prior to the Petition Date, the Petitioner entered into a loan and security agreement with certain lenders (the "Lenders"), which agreed to advance in excess of $100,000,000.00 to the Petitioner as capital for the purpose of funding the Petitioner's business operations.

The Lenders collateralized the revolving line of credit to the Petitioner by placing a lien on substantially all of the Petitioner's assets, including inventory which the Petitioner sold in its retail locations. This inventory collateral was very fluid and subject to daily, if not hourly, changes. Such fluctuation resulted as goods were sold by the Petitioner to its customers and then replenished through additional deliveries of inventory from its suppliers. The Lenders protected their floating lien position in the inventory with loan provisions stating that after acquired inventory would also serve as collateral for advances to the Petitioner from the line of credit.

On the Petition Date, the Petitioner filed a motion with the Bankruptcy Court to increase the amount of funding from the Lenders to $135,000,000.00 (the "DIP Financing Motion"). The DIP Financing Motion was granted by the Bankruptcy Court and provided the Petitioner with critical debtor-in-possession financing necessary to maintain its business operations during the reorganization process. The order approving the DIP Financing Motion (the "DIP Financing Order") granted the Lenders both super-priority liens on and claims against the Petitioner's assets pursuant to the applicable provisions of the Bankruptcy Code.

Both before and following the Petition Date, the Petitioner received written reclamation demands from its suppliers requesting the return of goods delivered during the ten days preceding the demand. The Petitioner ultimately received 141 reclamation demands from its vendors in the aggregate amount of approximately $18,000,000.00. The reclamation demands were submitted to the Petitioner pursuant to § 2-702 of the Uniform Commercial Code, which has been adopted in substantially the same form throughout the United States, including the State of Ohio where the Petitioner's corporate headquarters was located.

As is typical in larger retail or manufacturing bankruptcy cases, the Bankruptcy Court entered an order that established a procedure for the reconciliation and treatment of reclamation demands submitted by the Petitioner's vendors. The reclamation procedures order expressly preserved the Petitioner's right to assert that all of the reclamation claims submitted against its bankruptcy estate were valueless as a result of the superior secured inventory

liens granted to the Lenders under the loan agreements and applicable law (the "Bank Lien Defense").

STATEMENT OF THE CASE

On February 13, 2003, the Petitioner requested a ruling from the Bankruptcy Court on the Bank Lien Defense (the "Reclassification Motion"). Specifically, the Petitioner requested the Bankruptcy Court enter an order deeming all of the reclamation claims asserted against the bankruptcy estate, including the reclamation claim of the Respondent, to be classified as general unsecured claims. The Petitioner argued that the reclamation claims had no value because the goods delivered by the vendors were subject to the superior perfected security interests of the Lenders in those same goods.

The Bankruptcy Court entered its decision overruling the Reclassification Motion on November 12, 2003. (App. Pages 38a – 66a). Subsequently, the Bankruptcy Court entered orders on December 16, 2003 (App. Pages 29a – 37a) and December 18, 2003 (App. Pages 21a-28a) amending its earlier order.

The United States District Court for the Northern District of Ohio in Cleveland entered its order on October 6, 2005, affirming the order of the Bankruptcy Court. (App. Pages 14a – 20a).

On November 2, 2005, the Petitioner timely filed its notice of appeal from the District Court's order to the United States Court of Appeals for the Sixth Circuit. The Sixth Circuit entered an order (App. Pages 1a – 13a) on July 18, 2008, which affirmed the decisions of

the District Court and the Bankruptcy Court. In the reported opinion, the Sixth Circuit concluded that:

> "Ohio Rev. Code §1302.76(B) (UCC 2-702(2)) grants a properly reclaiming vendor, such as McKesson, a right to reclaim its goods and §1302.76(C) (UCC 2-702(3)) does not allow a secured creditor's claim to defeat that right." (App. Page 13a).

This reported decision on a crucial issue of commercial law will have a devastating impact upon secured loan transactions in this country because it effectively strips banks and other financial institutions of their priority security interest in inventory collateral in favor of a seller's reclamation claim.

REASONS FOR GRANTING THE PETITION

A. THE SIXTH CIRCUIT'S HOLDING THAT THE RIGHT OF A SUPPLIER TO RECLAIM GOODS IS SUPERIOR TO THE LIEN RIGHTS OF A SECURED CREDITOR IN THOSE SAME GOODS UNDERMINES THE INTEGRITY OF THE BANKING SYSTEM AND IS IN CONFLICT WITH THE FEDERAL COURTS IN THE OTHER CIRCUITS.

In its Opinion, the Sixth Circuit determined that: "[t]his case presents a question of law or an application of the law to the given circumstances, and the bankruptcy court's factual findings are immaterial to the disposition of this appeal." *Id.*, 534 F.3d 502, 504. The Court further noted that Section 546 of the Bankruptcy Code preserves a seller's state law reclamation rights in a buyer's bankruptcy proceeding.

and provides the bankruptcy court with the authority to grant a reclaiming creditor an administrative expense claim or a secured claim as an alternative remedy. *Id.* However, the Court also determined that a bankruptcy court must look to state law to determine the validity and priority of the vendor's reclamation claim in the first instance. *Id.*

The specific issue addressed in the Sixth Circuit Opinion was whether a bank holding a secured lien on inventory is a "good faith purchaser" under the reclamation section of the Uniform Commercial Code (2-702) with priority over the rights of an unpaid supplier. Because of the billions of dollars of asset based financing that takes place in the United States, this narrow legal issue has far reaching and potentially devastating implications on our nation's already fragile economy.

In virtually every state, a seller's right of reclamation is governed by §2-702 of the Uniform Commercial Code. These rights have been adopted in Ohio and are set forth in Ohio Revised Code §1302.76, titled "Seller's Remedies on Discovery of Buyer's Insolvency." (App. Page 70a). The statute, by its plain language, subjects the seller's reclamation claim to three separate categories of third-parties with superior rights in the goods: (1) "a buyer in ordinary course", (2) a "good faith purchaser", or (3) a "lien creditor under section 1302.44 of the Revised Code."

Prior to the Sixth Circuit's reported decision in this case, it was widely accepted that a secured creditor bank is a "good faith purchaser" under the Uniform Commercial Code, and that the rights of a reclamation creditor are subject to the superior rights of a secured

lender in the same goods. *See 5 Collier on Bankruptcy* ¶ 546-04[2][a] at 546-32 (Lawrence P. King, ed., 15th ed. rev. 2002) ("[T]he administrative expense priority claim or the secured claim may only be paid from the residual value of the goods after payment of all secured claims collateralized by the goods. If, in satisfying their claims, secured creditors take the entire value of the goods, the seller's administrative expense claim or lien is worthless and may not be satisfied from other assets of the estate.").

Significantly, the Sixth Circuit decision in this case is in conflict with the decision of the United States Court of Appeals for the Fifth Circuit on the same issue. In *Stowers v. Mahon (In re Samuels & Co.)*, 526 F.2d 1238 (5th Cir. 1976), *cert. denied* 429 U.S. 834, 97 S.Ct. 98, 50 L.Ed.2d 99 (1976), the Fifth Circuit determined that an unpaid seller's reclamation claim is inferior to a lender's security interest in inventory. The conflict among the circuits on the issue of whether a bank with a security interest in inventory can defeat an unpaid seller's reclamation claim will only create additional hesitation and uncertainty for underwriters and loan committees at our nation's financial institutions.

Other cases confirming that a right of reclamation is subject to the superior rights of a secured creditor are uniform and legion. *See*, *In re Dana Corp.*, 367 B.R. 409 (Bankr. S.D.N.Y. 2007), *In re Nitram, Inc.*, 323 B.R. 792 (Bankr. M.D. Fla. 2005), *In re Pittsburgh-Canfield Corp.*, 309 B.R. 277 (B.A.P. 6th Cir. 2004), *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003), *In re Flooring America, Inc.*, 271 B.R. 911 (Bankr. N.D. Ga. 2001), *In re Bridge Information Systems, Inc.*, 288 B.R. 133 (Bankr. E.D.

Mo. 2001), *In re Hartz Foods, Inc.*, 264 B.R. 33 (Bankr. D. Minn. 2001), *In re Primary Health Systems, Inc.*, 258 B.R. 111 (Bankr. D. Del. 2001), *In re Arlco., Inc.*, 239 B.R. 261 (Bankr. S.D.N.Y. 1999), *In re Steinberg's, Inc.*, 226 B.R. 8 (Bankr. S.D. Ohio 1998), *In re Affiliated of Florida, Inc.*, 237 B.R. 495 (Bankr. M.D. Fla. 1998), *In re Victory Markets Inc.*, 212 B.R. 738 (Bankr. N.D.N.Y. 1997), *In re American Spring Bed Manufacturing Company,* 153 B.R. 365 (Bankr. D. Mass. 1993), *In the Matter of Leeds Building Products, Inc.*, 141 B.R. 265 (Bankr. N.D. Ga. 1992), and *In re Child World, Inc.*, 145 B.R. 5 (Bankr. S.D.N.Y. 1992).

Many of these decisions were authored by some of the most respected and experienced jurists on the federal bench and are directly on point with the issues presented in the Petitioner's case. In *In re Dana Corp.*, 367 B.R. 409 (Bankr. S.D.N.Y. 2007), as in the Petitioner's case, the debtor obtained an order from the court to establish procedures to resolve approximately 450 reclamation claims asserted against its estate. *Id.* at 410. The procedures order entered in the *Dana* case was virtually identical to the order entered in the case *sub judice*, and included a provision preserving to the debtor the defense that the reclamation claims were valueless as a result of liens granted to secured creditors. *Id.* at 421. Following the payoff of a pre-petition bank loan through a DIP loan facility, the debtor in *Dana* filed a motion seeking a determination that the reclamation claims were valueless as a result of the bank lien defense.

The *Dana* Court expressly adopted the reasoning and analysis of the priority issues set forth in *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003), stating: "[i]n *Dairy Mart*, in

the context of a refinancing transaction substantially similar to the one presented here, the Court held that, where the claim of a prepetition secured lender with a floating lien on inventory is paid out of the proceeds of a postpetition credit facility supported by a new floating lien on inventory, the reclaimed goods securing the prepetition lender's debt effectively have been disposed in satisfaction of that debt. Such a sale of goods in satisfaction of prepetition secured debt renders all reclamation claims for those goods valueless. *Dairy Mart*, 302 B.R. at 135-36." *In re Dana Corp.*, 367 B.R. at 419.

The *Dana* Court further explained the impact of the DIP loan transaction on the asserted reclamation claims: "[t]he grant of the DIP Lien was a necessary condition of the DIP Lenders agreement to enter into the DIP Facility. Pursuant to the Final DIP Order, the Prepetition Indebtedness was refinanced and paid off using the proceeds of the DIP Facility on the payoff date. Because the reclaimed goods or the proceeds thereof were either liquidated in satisfaction of the Prepetition Indebtedness or pledged to the DIP Lenders pursuant to the DIP Facility, the reclaimed goods effectively were disposed as part of the March 2006 repayment of the Prepetition Credit Facility. Accordingly, the Reclamation Claims are valueless as the goods remained subject to the Prior Lien Defense. *Id.* at 421.

The Court in the *Dairy Mart* case, like the *Dana* Court, held that where the claim of a pre-petition secured lender with a floating lien on inventory is paid out of the proceeds of a post-petition credit facility supported by a new floating lien on inventory, the reclaimed goods securing the pre-petition lender's debt

effectively have been disposed of in satisfaction of that debt. Such a sale of goods in satisfaction of pre-petition secured debt renders all reclamation claims for those goods valueless.

The *Dairy Mart* Court explained the rationale behind its decision as follows: "[t]he only way the [Dairy Mart] Debtors could get a post-petition loan was if they afforded the debtor-in-possession lender a lien on all the pre-petition lender's collateral. In effect, that was the disposition of the collateral - the lien was given to the new lender in exchange for payment to Citizens or in effect 'sold' to the new lender. The transaction of releasing Citizens' lien and simultaneously granting the lien to the post-petition lender, Foothill, must be viewed as an integrated transaction.... There was a direct nexus between the release of the liens on the pre-petition collateral and the payment of the pre-petition secured loan....Thus, at the time that Citizens' secured claim was paid...,all of the goods or proceeds of those goods were disposed of to 'pay' Citizens' secured claim. In this context, the reclamation goods or the proceeds from those goods have been used to satisfy the secured creditor's claim. As such, the goods or their proceeds have effectively been 'paid' to the secured creditor and the Reclamation Claims in those goods is valued at zero." *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. at 135-6.

Similarly, the court in *In re Pittsburgh-Canfield Corp.*, 309 B.R. 277, 287 (B.A.P. 6th Cir. 2004), explained in great detail the reasoning why a bank's UCC Article 9 lien on inventory is superior to a reclamation claim. The Court's explanation centered on the concept that: "[b]ecause the buyer retains the apparent authority to deal with goods, the sale of

goods to a good faith purchaser cuts off a seller's right to reclaim" and that since "[m]ost secured creditors are good faith purchasers under the Uniform Commercial Code . . . the rights of a reclaiming seller generally will be inferior to those of a secured creditor who has a security interest in the goods but superior to those of the buyer's general unsecured creditors." *Id.* at 284. The Court then went on to hold that a "reclaiming seller is entitled to a lien or administrative expense claim only to the extent that the value of the specific inventory in which the reclaiming seller asserts an interest exceeds the amount of the floating lien in debtor's inventory" because "[i]f the remedy under state law has no value, [then] the substitute remedy afforded by the Code would, likewise have no value." *Id.* at 288.

In re Bridge Information Systems, Inc., 288 B.R. 133 (Bankr. E.D. Mo. 2001) is another decision that, like the *Dana*, *Dairy Mart* and *Pittsburgh-Canfield* cases, directly addresses the superior rights held by a secured lender, as a good faith purchaser, over a reclaiming seller in inventory collateral. There, the Court determined the priority between Dell Receivables, L.P. (the reclaiming seller) and Goldman Sachs (the DIP lender) against the subject goods. The *Bridge* Court stated in its decision that: "Dell has failed to produce any evidence that its state law right to reclaim the equipment survived Goldman Sachs' blanket security interest in Bridge's assets as provided in the Court's order approving Goldman Sachs' provision of post-petition financing to Bridge (the 'DIP Order'). Accordingly, Dell's motion will be denied." *Id.* at 136. Further, the Court held that: "Dell's state law reclamation right did not survive Goldman Sachs' lien". *Id.* at 137-138. Because the *Bridge* Court

concluded that Goldman Sachs' blanket priority lien on all of Bridge's assets was superior to the reclamation demand submitted by Dell, Dell's reclamation claim had no value.

In addition, the decisions in *In re Arlco, Inc.*, 239 B.R. 261, 267 (Bankr. S.D.N.Y. 1999) ("[m]ost courts have treated a holder of a prior perfected, floating lien on inventory. . . as a good faith purchaser with rights superior to those of a reclaiming seller"), and *In re Steinberg's, Inc.*, 226 B.R. 8, 10 (Bankr. S.D. Ohio 1998) ("[t]he courts in this circuit, as well as others, have overwhelming concluded that a holder of a perfected floating lien on inventory qualifies as a good faith purchaser with rights superior to that of a reclaiming seller"), offer significant insight and analysis of the collection of cases which overwhelmingly support the superior rights that a secured creditor, as a good faith purchaser, have over reclaiming vendors.

Notwithstanding the applicability of all the foregoing cases to the Petitioner's case, the Sixth Circuit rejected the rationale and holdings of each of these decisions, opining that, "these holdings are not practical and their reasoning is not compelling." (App. Page 11a). The Sixth Circuit further stated that the opinion of the Sixth Circuit Bankruptcy Appellate Panel in *Pittsburgh-Canfield Corp., supra,* was "simply not persuasive" and "contradicts [the Sixth Circuit Court of Appeals] reasoning, if not our holdings, in *Mel Golde Shoes* and *Federal's*." (App. Page 11a).

By relying upon the *Mel Golde Shoes* and *Federal's* cases along with a 1974 decision from a Georgia bankruptcy court, *In re American Food Purveyors, Inc.*,

1974 WL 21665, 17 UCC Rep. Serv. 436 (Bankr. N.D. Ga. 1974), the Sixth Circuit arrived at a conclusion of law that radically undermines a secured creditor's priority position in inventory collateral, deviates from an otherwise homogeneous application of the Uniform Commercial Code, and creates a conflict with federal courts in other circuits. Furthermore, the *Mel Golde Shoes* and *Federal's* cases are readily distinguishable as neither addressed the issue presented in this case: the priority rights of a secured creditor as a "good faith purchaser" under Section 2-702 of the Uniform Commercial Code.

In *Matter of Federal's, Inc.*, 553 F.2d 509, 510 (6th Cir. 1977) the court addressed the following issue: "[i]n this appeal, we consider whether § 2-702(2) of the Uniform Commercial Code, as enacted in Michigan, grants to the seller of goods a right of reclamation superior to the right of the insolvent buyer's trustee in bankruptcy and if so, whether that right must be invalidated as conflicting with Sections 64 and 67c(1)(A) of the Bankruptcy Act." Thus, *Federal's* involved an argument by the trustee that he could avoid reclamation claims based upon hypothetical judgment lien creditor status. The *Federal's* Court specifically noted that the trustee "has the lien of an execution creditor, which is about the lowest form of security." *Id.* at 513. It must be underscored that *Federal's* is not a good faith purchaser bank lien case. It is a judgment or execution lien case under the former Bankruptcy Act, while the Petitioner's case, in contrast, addresses the liens of a UCC Article 9 good faith purchaser (secured lender) vis-à-vis the rights of a reclaiming creditor.

Similarly, *In re Mel Golde Shoes*, 403 F.2d 658 (6th Cir. 1968), is also inapplicable since it addressed the separate issue of whether the right of a seller to reclaim goods took priority over an attachment lien levied on the goods by a judgment creditor of the buyer. There the court held that the judgment lien creditor's attempt to attach the buyer's inventory could be defeated by a creditor asserting a right of reclamation on those same goods. The statutory rights of a bank as a good faith purchaser having a floating lien on inventory were not addressed in that decision.

The Sixth Circuit also relied upon the 1974 decision of *In re American Food Purveyors, Inc., supra*, which did address the good faith purchaser issue present in the Petitioner's case. The *American Food Purveyors* Court found that UCC § 2-702 "was never designed to protect Article 9 secured creditors, only Article 2 'purchasers'." *Id.* at 441. Because the holding of the *American Food Purveyors* case completely deviates from the other reported decisions addressing the same issue and has been highly criticized by other courts, the Sixth Circuit's reliance upon that case to reach such an anomalous decision is shocking. *See In re Arlco, Inc.*, 239 B.R. at 268-70 (*collecting cases*).

The *Arlco* Court also noted at page 270 that the bankruptcy judge who authorized the renegade 1974 *American Food Purveyors* opinion, W. Homer Drake, reached the opposite conclusion on the same issue in the *Matter of Leeds Building Products Inc.*, 141 B.R. 265 (Bankr. N.D. Ga. 1992) decision he authorized 18 years later. In *Leeds*, Judge Drake held that a secured party lender with a lien in a debtor's inventory qualified as a "good faith purchaser" under Section 2-702 of the UCC, with priority over the rights of a

reclamation claimant. It is noteworthy that Judge Drake did not even mention his 1974 *American Food Purveyors* decision in the *Leeds* case. Based upon the foregoing, it is difficult to understand how the Sixth Circuit could rely upon *American Food Purveyors* to support its isolated conclusion that secured lenders are not "good faith purchasers" under Section 2-702 of the UCC.

The Petitioner respectfully submits that the Sixth Circuit's reliance upon the holdings of the foregoing *three* cases in its opinion, and complete rejection of the legion of other federal decisions directly on point is alarming. Allowing such an opinion to remain established precedent in the Sixth Circuit would eviscerate the superior statutory rights of lending institutions, as good faith purchasers, over the rights of reclaiming creditors, with devastating consequences to financial and business institutions.

The decisions in *Dana, Dairy Mart, Bridge Information Systems, Arlco, Steinberg's* and *Pittsburgh-Canfield*, are directly on point with the issues presented in this case, but the rationale of those cases were completely rejected by the Sixth Circuit based upon a view that their holdings were "not practical", "not compelling", and "not persuasive". The Petitioner asserts that such a conclusion on this multibillion dollar recurring issue could not be more unfounded or have any greater potential for catastrophic consequences.

This continued vacillation and uncertainty alone justifies review. *Calhoon v. Harvey*, 379 U.S. 134, 137 (1964) (granting *certiorari* because of the "importance of the questions presented and conflicting views in the

courts of appeals and district courts"); *Dawson Chemical Co. v. Rohm & Haas Co.*, 448 U.S. 176 (1980) (*certiorari* granted "to forestall a possible conflict in the lower courts" on an "important" issue even though there was no "direct conflict" among various district court and court of appeals opinions).

The decision of the Sixth Circuit creates a split among the federal circuits and lower courts that brings this Petition squarely with the ambit of this Court's discretionary jurisdiction and presents an opportunity to prevent the devastating impact to commercial lending that will result from inaction and uncertainty on this issue. The time has come to settle the debate.

B. THE TIME HAS COME TO SETTLE THE DEBATE OVER THE PRIORITY BETWEEN A BANK HOLDING A SECURED LIEN ON INVENTORY AND A VENDOR ASSERTING A RECLAMATION CLAIM AGAINST THE SAME GOODS.

The ultimate question necessary to determine the priority between a secured creditor and a reclaiming vendor is whether the former is entitled to good faith purchaser status under the Uniform Commercial Code. Based upon the Sixth Circuit's decision in this case, all parties to commercial transactions, including lenders, borrowers and vendors, are placed into a sea of uncertainty depending upon which jurisdiction the issue is presented.

The implications of the Sixth Circuit's decision reach far beyond the parties in the Petitioner's case. This decision is a catalyst for severe disruption of the commercial lending system, an institution which can only function properly in an environment where the

rules are uniform and the certainty of priority position is sacrosanct. Given the dramatic economic turbulence in the nation's financial markets, the introduction of additional uncertainty into the commercial lending system, specifically with regard to the priority position in collateral, will only serve to tighten lending standards. Such uncertainty will also extend and magnify the lack of confidence lenders exhibit in making commercial loans, thereby depriving businesses of desperately needed operating capital.

Asset-based lenders, unsure of their priority position in a borrower's inventory, will have no choice but to carve out any inventory collateral which a reclaiming vendor may attempt to strip away, thereby reducing the amount of working capital for retailers and manufacturers.

In addition, it is clear that the Sixth Circuit decision has generated a vast amount of debate in the professional communities called upon to advise the various parties in such commercial transactions. By way of example, the itinerary for the American Bankruptcy Institute's 27th Annual Spring Meeting, scheduled on April 1-4, 2009 in National Harbor, Maryland, lists as Uniform Commercial Code, Topic 1, "Reclamation and 503(b)(9) Issues in the Aftermath of Sixth Circuit's Decision in *Phar-Mor vs. McKesson*." This conference is the preeminent gathering of commercial law practitioners from around the nation and the decision which is the subject of this Petition will be the topic of continued debate and uncertainty. It is noteworthy that the seminar title includes the word "aftermath." Aftermath is not a word generally viewed as positive but instead is associated with a disaster.

The present case provides an opportunity for this Court to resolve the debate and conflict among the Fifth and Sixth Circuits and other federal courts on the issue of whether a secured creditor is a good faith purchaser under Section 2-702 of the Uniform Commercial Code, with rights superior to a reclaiming creditor. Failure to act decisively may well be the final catastrophic straw which breaks the back of a banking system reeling under a severe economic crisis not seen in decades.

CONCLUSION

For the above and foregoing reasons, the Petitioner respectfully requests that a writ of *certiorari* be granted in this case.

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APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Nos. 05-4525/4526

[Filed July 17, 2008]

PHAR-MOR, INC.,
Appellant,

v.

MCKESSON CORPORATION,
Appellee.

Appeal from the United States District Court
for the Northern District of Ohio at Youngstown.
Nos. 04-01013; 04-01015—
Christopher A. Boyko, District Judge.

Before: BATCHELDER, Circuit Judge;* BUNNING, District Judge.**

* The Honorable Karen Nelson Moore, Circuit Judge, was present at oral argument but did not take part in the consideration or decision of the case.

** The Honorable David L. Bunning, United States District Judge for the Eastern District of Kentucky, sitting by designation.

OPINION

ALICE M. BATCHELDER, Circuit Judge. At issue in this bankruptcy case is whether a vendor's administrative-expense priority on its reclamation claim is effectively extinguished when the goods subject to reclamation are sold and the proceeds used to satisfy a secured creditor's superior claim. Because we hold that it is not, we AFFIRM the district court's decision.

I.

Phar-Mor, Inc. filed Chapter 11 bankruptcy on September 24, 2001, but continued to operate as a debtor in possession (DIP). In response, several vendors, including McKesson Corporation, filed timely "reclamation claims," pursuant to 11 U.S.C. § 546(c) and Ohio Rev. Code § 1302.76 (UCC § 2-702), seeking to recover goods they had delivered to Phar-Mor on credit. On October 5, 2001, Phar-Mor proposed "that each Vendor be granted an administrative expense priority claim under Section 503(b) in the amount (if any) of its allowed reclamation claim," and reported reclamation claims from 141 vendors totaling $18 million. All but McKesson have since settled.

On the petition date, Phar-Mor owed its secured creditors $103 million. The bankruptcy court authorized Phar-Mor to borrow up to $135 million to repay these pre-petition secured creditors.[1] Phar-Mor

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[1] The bankruptcy court authorized Phar-Mor to borrow the $135 million and gave the DIP Lenders super-priority status in an Interim Order dated September 24, 2001 (the petition date).

did so and those security interests were extinguished. Phar-Mor gave the new creditors (i.e., "DIP Lenders") super-priority status over the remaining security interests, which also meant that their claims had priority over any administrative expense claims, such as McKesson's.

Upon entering bankruptcy, Phar-Mor closed 65 stores and held going-out-of-business sales, which generated $30 million. Phar-Mor continued to lose money, continued to close stores, and eventually had a final going-out-of-business-liquidation sale, which generated $103 million. Phar-Mor was able to pay off the $135 million post-petition loan from the DIP Lenders and was left with $64.5 million. After expenses, fees, and the money allotted to payment of the reclamation claims, $30 million was left towards payment of $185.5 million in general unsecured claims.

On February 13, 2003, Phar-Mor moved the bankruptcy court to reclassify the reclamation claims as general unsecured claims. Phar-Mor argued that the vendors' administrative-expense priority was extinguished when the goods subject to reclamation were sold and the proceeds used to pay off the DIP Lenders. The court denied the motion and held that, even though the reclamation claims were rendered "subject to" the DIP Lenders' super-priority, the vendors' properly filed reclamation claims still had

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Phar-Mor borrowed the money, repaid the pre-petition secured creditors (extinguishing their security interests), and gave the DIP Lenders super-priority security interests that same day. The bankruptcy court formalized this authorization in a Final Order dated October 23, 2001.

administrative-expense priority over the general claims.

Phar-Mor moved the bankruptcy court for reconsideration (twice), and was denied (twice); appealed to the district court, which affirmed the bankruptcy court; and now appeals to this court — each time asserting the same arguments that it had asserted to the bankruptcy court in the first instance. Because we find that the bankruptcy court properly granted McKesson an administrative expense priority in lieu of its reclamation claim, we affirm the bankruptcy court's decision.

II.

"We review the bankruptcy court's decision directly, according no deference to the district court. The bankruptcy court's findings of fact are reviewed for clear error, and questions of law are reviewed *de novo*." *In re S. Air Transp., Inc.*, 511 F.3d 526, 530 (6th Cir. 2007) (citation omitted). This case presents a question of law or an application of the law to the given circumstances, and the bankruptcy court's factual findings are immaterial to the disposition of this appeal.

The parties do not dispute the meaning or effect of the bankruptcy code provision in this case — a provision that has since been amended. The prior (applicable) version states, in pertinent part:

> [T]he rights and powers of a trustee . . . are subject to any statutory or common-law right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's

> business, to reclaim such goods if the debtor has received such goods while insolvent, but — . . . the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court —
>
> (A) grants the claim of such a seller priority as a claim of a kind specified in section 503(b) of this title [i.e., an administrative expense]; or
>
> (B) secures such claim by a lien.

11 U.S.C. § 546(c)(2) (1998) (amended in 2005 by Pub. L. 109-8, § 1227(a)). There is no question that McKesson sold goods to Phar-Mor in the ordinary course of its business, that Phar-Mor received the goods while insolvent, or that McKesson, upon discovering Phar-Mor's insolvency, made a timely, written demand for reclamation. The immediate question is whether McKesson had a statutory or common-law right, pursuant to Ohio law, to reclaim those goods. If so, then the court, having denied reclamation, was obligated to grant McKesson either an administrative-expense priority in the amount of the goods (as it did) or a lien on the proceeds resulting from the use of those goods by the debtor. But if not, then the court was not so obliged and McKesson's claim for the value of those goods may be properly regarded as merely a general unsecured claim.

Ohio statute provides an aggrieved seller with a right to reclaim its goods, and that right stems from "the proposition that any receipt of goods on credit by an insolvent buyer amounts to a tacit business misrepresentation of solvency and therefore is

fraudulent as against the particular seller." Ohio Rev. Code § 1302.76 (Official Comment 2 (1961)). This particular provision states:

> Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this division the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

Ohio Rev. Code § 1302.76(B). In addition to creating (or codifying) this *right* to reclaim, this same statute also governs the aggrieved seller's *ability* to reclaim the goods in question, stating:

> The seller's right to reclaim under division (B) of this section is subject to the rights of a buyer in ordinary course or other good faith purchaser or lien creditor under section 1302.44[2] of the

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[2] Section 1302.44 of the Ohio Revised Code, titled "Power to transfer; good faith purchase of goods; entrusting defined," states in pertinent part:

> A purchaser of goods acquires all title which the transferor had or had power to transfer except that a purchaser of a limited interest acquires rights only to the extent of the interest purchased. A person with voidable title has power to transfer a good title to a good faith

> Revised Code. Successful reclamation of goods excludes all other remedies with respect to them.

Id. at § 1302.76(C). The statute's accompanying commentary explains that "[b]ecause the right of the seller to reclaim goods under this section constitutes preferential treatment as against the buyer's other creditors," successful reclamation bars the seller from pursuing any other remedies from the buyer, *id.* at Official Comment 3 (1966) — that is, the buyer is not treated as having breached the contract (by failing to pay), but rather, the contract is rescinded and the reclaimed goods are returned to the seller as though the contract had never been entered and the goods never delivered.

It appears clear from the plain language of this statute that McKesson had the *right* to reclaim the goods delivered to Phar-Mor. *See id.* at § 1302.76(B). This finding — that McKesson had a right to reclaim the goods — would seem to answer the pending question and end our analysis; the court, having denied reclamation, was indeed obligated to grant McKesson a priority on its claim, which it did by

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> purchaser for value. When goods have been delivered under a transaction of purchase, the purchaser has such power even though:
>
> . . .
>
> (4) The delivery was procured through fraud punishable as larcenous under the criminal law.

Ohio Rev. Code (4) § 1302.44(A) (UCC 2-403).

granting the administrative-expense priority in the amount of the goods.

Phar-Mor argues, however, that McKesson did not have a *right* to reclaim the goods because McKesson did not have the *ability* to reclaim those goods, inasmuch as § 1302.76(C) renders a seller's right to reclaim "subject to the rights of a buyer in ordinary course or other good faith purchaser or lien creditor." Phar-Mor contends that the DIP Lenders, who held a security interest in all of Phar-Mor's inventory, via an after-acquired-property clause in their security agreement, *see* Ohio Rev. Code § 1309.204, were "good faith purchasers." *See In re Pester Ref. Co.*, 964 F.2d 842, 844 (8th Cir. 1992) (stating that "most secured creditors are good faith purchasers under the UCC"). Thus, Phar-Mor surmises that, because McKesson's reclamation rights are "subject to" the DIP Lenders' security interest and because Phar-Mor sold McKesson's "reclamation goods" to satisfy the DIP Lenders' claim, McKesson is unable to reclaim the goods and, hence, is left without any *right* to reclaim the goods. *But see id.* at 846 (holding that an aggrieved seller's "right to reclaim was not extinguished because [the debtor] had secured creditors with perfected security interests").

In the case of *In re Mel Golde Shoes, Inc.*, 403 F.2d 658, 661 (6th Cir. 1968), we held that, under Kentucky law, a defrauded seller's right to reclaim his goods is superior to any right of attaching creditors, despite UCC 2-702's "subject to" provision. In finding that the secured creditor was not the type of good faith purchaser that would overcome the vendor's right to reclamation, we adopted some reasoning from a Kentucky Court of Appeals decision and said:

> [N]o reason exists why, as between attaching creditors and vendors asserting an enforceable equity growing out of the contract of sale, the latter should not be preferred. It would certainly be unjust to subject to the payment of the debts of their fraudulent vendee, goods he had improperly obtained from them, and which in equity, they were entitled to reclaim. This would virtually secure to such vendee the fruits of his fraud by the payment of his debts to the extent of the value of the goods, and defeat the equity of the vendor and the object of the statute.

Id. at 660 (quotation marks and citation omitted). Elsewhere, we reasoned similarly on a similar issue; this time considering the question from the viewpoint of Michigan law:

> [W]e agree that the rights reserved to the defrauded seller under [UCC 2-702] are the direct descendants of those historically preserved under the common law and so respected by the Bankruptcy Act. They are rights with respect to particular goods and in which the purchaser's title was historically voidable. In contrast, a priority within the meaning of the Bankruptcy Act contemplates a claim which is satisfied from the general assets of the bankrupt's estate and is asserted after the satisfaction of secured liens but before the debts of general creditors. A priority in bankruptcy should not depend for its existence upon the contingency of whether specific assets are within the bankrupt's estate. While the district court rejected this distinction because 'if

> reclamation is permitted in bankruptcy it will reduce the bankrupt's estate at the obvious expense of all the unsecured creditors,' the logic is unpersuasive. The best response is that of Judge Blackmun in *O'Rieley v. Endicott-Johnson Corp.*, 297 F.2d 1, 9 (8th Cir. 1961), wherein the court upheld a pre-Code seller's petition for reclamation of goods sold to the bankrupt:
>
> 'While we realize that a decision in favor of Endicott has the practical effect, as pointed out by the Trustee in its argument, of favoring one creditor over the general creditors, this is necessarily true of any successful reclamation petition. It would be unjust to permit general creditors to benefit at the expense of one whose assets come into a bankrupt's possession under conditions which warrant rescission.'

In re Federal's Inc., 553 F.2d 509, 518 (6th Cir. 1977) (editorial marks and citations omitted).

Phar-Mor relies on *In re Pittsburgh-Canfield Corp.*, 309 B.R. 277, 287 (B.A.P. 6th Cir. 2004), for the proposition that, when the goods subject to reclamation are sold to satisfy a secured creditor's superior claim, the goods subject to reclamation are gone and the vendor's right to a priority claim is gone with them. But, decisions by the Bankruptcy Appellate Panels are not binding on us, *see Weber v. United States*, 484 F.3d 154, 158 (2d Cir. 2007) (citing H.R. Rep. No. 109-31 at 148 (2005), U.S. Code Cong & Admins. News 2005, 88, 206; H.R. Rep. No. 107-3, Prt. 1 at 112 (2001)); *In re Healthcentral.com*, 504 F.3d 775, 784 n.3 (9th Cir. 2007), and this proposition — which

contradicts our reasoning (if not our holdings) in *Mel Golde Shoes* and *Federal's* — is simply not persuasive. As we said in *Federal's*, 553 F.2d at 518, "A priority in bankruptcy should not depend for its existence upon the contingency of whether specific assets are within the bankrupt's estate." And, as we said in *Mel Golde Shoes*, 403 F.2d at 660, "It would certainly be unjust to subject to the payment of the debts of their fraudulent vendee, goods [the vendee] had improperly obtained from [the aggrieved vendors], and which in equity, [the vendors] were entitled to reclaim."

For these same reasons, Phar-Mor's reliance on *In re Dana Corp.*, 367 B.R. 409 (Bankr. S.D. N.Y. 2007), *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128 (Bankr. S.D. N.Y. 2003), *In re Bridge Information Systems, Inc.*, 288 B.R. 133 (Bankr. E.D. Mo. 2001), *In re Arlco, Inc.*, 239 B.R. 261 (Bankr. S.D. N.Y. 1999), and *In re Steinberg's, Inc.*, 226 B.R. 8 (Bankr. S.D. Ohio 1998), is similarly unavailing. These holdings are not practical and their reasoning is not compelling. *See, e.g.*, Lisa Gretchko, *Seller Beware! Is your Reclamation Claim as Strong as you Think it Is?* 22-MAR Am. Bankr. Inst. J. 20, 50 (2003) (noting that these cases are "insensitive to the reality that inventory is often liquidated first and the proceeds paid to the secured creditor, and ignore[] the protection that UCC § 2-702 and Code § 546(c)(2) intended to give to reclaiming vendors").

In contrast, the court in *American Food Purveyors*, considering the UCC as codified in Georgia, adopted the reasoning of *Mel Golde Shoes*, 403 F.2d at 661, and held that a defrauded seller's right to reclaim goods is superior to any right of an attaching creditor, explaining:

The issues of good faith, notice and knowledge are important here because [the after-acquired-property secured creditor] is attempting to acquire rights over goods which were essentially being held in trust by [the debtor/buyer] for [the seller], because of their acquisition by fraud. It was as if [the debtor/buyer] never had obtained title, and [the seller] is essentially trying to retake his own property. For these reasons, and because this is a court of equity and guided by equitable doctrines and principles, it was essential that [the creditor] demonstrate that it was in good faith and had no knowledge or notice of [the debtor/buyer]'s financial plight, in order to prevail.

For the reason that the property was still [the seller]'s even after it was delivered, at least for the ten day period provided for in § 2-702, the court finds further that [the creditor] acquired no 'rights in the collateral' as required under [UCC § 9-204], in regard to the [goods, i.e.,] 400 cases of perch. [A] secured party's rights, generally speaking, against the debtor's vendor are no greater than the debtor himself.

The court finds that rights under § 9-204 of the UCC means an ownership claim paramount to that of the seller and capable of specific enforcement in equity. Consequently, for the ten day period in question, [the debtor/buyer] could not have sustained an action in equity to keep these goods. All of the rights during this period were with the defrauded seller[].

In re Am. Food Purveyors, Inc., 17 UCC Rep. Serv. 436, 1974 WL 21665 (Bankr. N.D. Ga. 1974) (no page numbers available; quotations and citations omitted). This reasoning is persuasive.

We find that Ohio Rev. Code § 1302.76(B) (UCC 2-207(2)) grants a properly reclaiming vendor, such as McKesson, a right to reclaim its goods and that § 1302.76(C) (UCC 2-207(3)) does not allow a secured creditor's claim to defeat that right. But, correspondingly, we find that 11 U.S.C. § 546(c)(2) (1998) grants the bankruptcy court the power to deny a properly reclaiming vendor, such as McKesson, its right to reclaim the goods, but only by granting the denied vendor either an administrative-expense priority in the amount of the goods or a lien on the proceeds resulting from the use of those goods by the debtor. In this case, the bankruptcy court granted McKesson an administrative-expense priority, and we have no basis to overturn its decision in this matter.

III.

Based on the foregoing, we **AFFIRM** the district court's decision.

APPENDIX B

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF OHIO
EASTERN DIVISION

Nos. 4:04CV1013 & 4:04CV1015

[Filed October 6, 2005]

PHAR-MOR, INC., Appellant,	)
vs.	)
McKESSON CORP. et al., Appellees.	)

OPINION AND ORDER

CHRISTOPHER A. BOYKO, J.:

This matter comes before the Court upon the consolidated appeals from the orders, dated November 12, 2003, December 16, 2003 and December 18, 2003, of U.S. Bankruptcy Judge William T. Bodoh overruling the Debtor Phar-Mor, Inc.'s motion to determine the reclamation claims to be general unsecured claims and objecting to the allowance of such claims as entitled to administrative priority. Oral arguments were conducted on June 7, 2005. For the reasons that follow,

and based upon the applicable law, arguments and briefs, the ruling of the Bankruptcy Judge is affirmed.

I. FACTUAL AND PROCEDURAL BACKGROUND

On September 24, 2001, Phar-Mor and affiliated debtors (collectively "Phar-Mor") filed their voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code. Prior to the petition date, in the ordinary course of business, Phar-Mor purchased and received goods from various suppliers for the operation of the deep discount drug store chain. Both before and after the petition date, Phar-Mor received reclamation demands from vendors asserting rights of reclamation pursuant to state law and §546(c) of the United States Bankruptcy Code.

On January 9, 2002, the Bankruptcy Court entered a Reclamation Procedures Order: (1) prohibiting third parties from interfering with Phar-Mor's receipt, use or disposition of goods and (2) establishing procedures for the liquidation and treatment of reclamation claims. After factual disputes were resolved and the amount of reclamation claims determined, the Order provided that Phar-Mor would either "commence further proceedings to determine the extent to which the Reclamation Claim amounts are subject to further defenses by reason of liens granted to the Debtors' secured creditors," or alternatively, "propose to resolve such issues through a proposed plan of reorganization that specifies the extent to which the Reclamation Claims shall be treated as allowed administrative expense priority claims."

There are four reclamation claims at issue: McKesson Corp., The Pepsi Bottling Group, Inc., The Dial Corporation, and Liquidity Solutions, Inc. (holder by assignment of the claim of Frito-Lay, Inc.); and at the oral arguments, Phar-Mor acknowledged that the validity and amounts of the claims are not in dispute.

Prior to filing for bankruptcy, Phar-Mor entered into a loan and security agreement ("Pre-Petition Credit Agreement") dated November 16, 2000 with certain financial institutions and Fleet Retail Finance, Inc. as agent, in the amount of One Hundred Three Million Five Hundred Ten Thousand Dollars ($103,510,000.00). On September 24, 2001, Phar-Mor moved for, and was granted, approval of a debtor-in-possession credit facility ("DIP Facility"). Later, on October 23, 2001, the bankruptcy court entered a final order approving the DIP Facility ("Final DIP Order"). The Final DIP Order authorized Phar-Mor to borrow up to One Hundred Thirty-Five Million Dollars ($135,000,000.00) to repay all obligations owed to Pre-Petition Lenders under the Pre-Petition Credit Agreement. Said payments were ratified and confirmed in the Final DIP Order.

According to the Final DIP Order, upon receipt of these payments, any liens or security interests granted in favor of the Pre-Petition Lenders were released and extinguished. There was no provision in the Final DIP Order for any transfer or assignment of liens or security interests to Post-Petition lenders. Instead, the Final DIP Order provided that the new liens would have priority over any other security, mortgage, or lien; would be granted the status of a "super-priority claim" over all allowed administrative expense claims;

and would be provided a priority over all reclamation claims.

On February 13, 2003, Phar-Mor filed a motion for entry of an order determining reclamation claims to be general unsecured claims. Judge Bodoh, through his three orders, granted the motion in part and denied it in part. He held that the reclamation claims attributable to demands received prior to September 24, 2001 should be granted an administrative priority pursuant to § 546(c), and those reclamation claims attributable to demands received on or after September 24, 2001 should be allowed only as general unsecured claims. The instant consolidated appeals followed.

II. LAW AND ANALYSIS

STANDARD OF REVIEW

In reviewing a bankruptcy proceeding, "the district court reviews the bankruptcy court's conclusions of law de novo and upholds its findings of fact unless they are clearly erroneous." *In re: Made in Detroit, Inc.*, 414 F. 3d 576, 2005 Fed. App. 0286P, *8 (6th Cir., July 1, 2005); *255 Park Plaza Assocs. Ltd. P'ship v. Conn. Gen Life Ins. Co.* (*In re 255 Park Plaza Assocs. Ltd. P'Ship*), 100 F. 3d 1214, 1216 (6th Cir. 1996). "Where a bankruptcy court's determination involves a mixed question of fact and law, the district court "must break it down into its constituent parts and apply the appropriate standard of review for each part." *Wesbanco Bank Barnesville v. Rafoth* (*In re Baker & Getty Fin. Servs., Inc.*), 106 F. 3d 1255, 1259 (6th Cir. 1997)(*quoting Investors Credit Corp. v. Batie* (*In re Batie*), 995 F. 2d 85, 88 (6th Cir. 1993)). A challenge to

a determination of administrative claims is reviewed under an abuse of discretion standard. *Yenkin-Majestic Paint Corp. v. Wheeling-Pittsburgh Steel Corp.* (*In re Pittsburgh-Canfield Corp.*), 309 B.R. 277, 281 (B.A.P. 6th Cir. 2004). Moreover, a bankruptcy court's interpretation and implementation of its own orders is afforded substantial deference and is reviewed under an abuse of discretion standard. *Kendrick v. Blank*, 931 F. 2d 421, 423 (6th Cir. 1991).

ISSUES PRESENTED

Referencing Paragraph 8 on Page 6 of his Final DIP Order, Judge Bodoh found that the Pre-Petition debt was fully satisfied and that there was no transfer or assignment of any lien or security interest to the DIP Lenders. The language of the Final DIP order is not ambiguous. Phar-Mor, as well as the vendors, were afforded a fair opportunity to be heard by way of briefs and hearings; so, Judge Bodoh did not act capriciously nor abuse his discretion. This Court must defer to the Bankruptcy Judge's interpretation of his own orders. *Kendrick*, *supra*. Judge Bodoh found that the Pre-Petition Lenders elected to release their security interests and were paid in full, and that their security interests were not assigned nor preserved. Therefore, Judge Bodoh appropriately further found that the reclamation claims were not extinguished nor rendered worthless. Instead, the reclamation claims, attributable to demands received prior to September 24, 2001, deserved to be granted an administrative priority pursuant to United States Bankruptcy Code § 546(c).

Judge Bodoh made the factual determination that the DIP Lenders were not good faith purchasers under

§ 2-702 of the Uniform Commercial Code. He noted that the DIP Lenders were aware of the existence of the reclamation creditors through the Reclamation Procedures Order, the Reclamation Claims Report, other orders, filings and hearings in the extensive underlying bankruptcy proceeding. Moreover, the DIP Lenders are sophisticated lenders with knowledge of the Debtor's business operations and supplier needs. Such lenders fail to meet the standard of "good faith" under § 9-102 of the Uniform Commercial Code, which is defined as: "honesty in fact and the observance of reasonable commercial standards of fair dealing." This Court will not disturb Judge Bodoh's finding that the DIP Lenders cannot defeat the reclamation sellers' rights.

Phar-Mor asserts that the language of the Post-Petition loan documents enables the Pre-Petition Lenders to preserve their liens despite the satisfaction of the debt. First, this Court must defer to the interpretations enunciated by the Bankruptcy Judge. Second, even if this Court were to accept Phar-Mor's view and note an inconsistency between the documents and the Final Order, this Court is compelled to look to Paragraph 36 of that Order. That paragraph recites as follows: "In the event of any inconsistency between the terms and conditions of any Loan Document and of this Order, the provisions of this Order shall govern and control."

In consideration of judicial economy and the finality of judgments, and with an awareness of its role as an appellate court, this Court declines to entertain arguments and issues which were not presented in the first instance in the Bankruptcy Court. *Friendly Farms v. Reliance Insurance Company*, 79 F. 3d 541,

544 (1996); *Taft Broadcasting Company v. United States*, 929 F. 2d 240, 243-244 (1991). Since Phar-Mor neglected to press the issue below that Judge Bodoh misread the loan documents or misinterpreted his own orders, those arguments are waived and will not be addressed.

III. CONCLUSION

Upon review of the briefs, arguments and applicable law, and for the reasons articulated above, the Orders, dated November 12, 2003, December 16, 2003, and December 18, 2003, issued by U.S. Bankruptcy Judge William T. Bodoh on the reclamation claims of McKesson Corp., The Pepsi Bottling Group, Inc., The Dial Corporation, and Liquidity Solutions, Inc. (holder by assignment of the claim of Frito-Lay, Inc.) are affirmed.

IT IS SO ORDERED.

DATE: 10/05/05

/s/ Christopher A. Boyko
CHRISTOPHER A. BOYKO
United States District Judge
(Signed original on file)

APPENDIX C

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO

JOINTLY ADMINISTERED

No. 01-44007

[Filed December 18, 2003]

IN RE:	)
	)
PHAR-MOR, INC., *et al.*,	)
Debtors.	)
	)

AMENDED ORDER

This cause is before the Court on the motion of Phar-Mor, Inc. and related entities ("Debtors") for reconsideration of this Court's prior memorandum opinion and order overruling Debtors' motion for entry of an order determining all reclamation claims to be general unsecured claims pursuant to 11 U.S.C. § 502(j) and FED. R. BANKR. P. 3008. The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157(b) and 1334(b).

DISCUSSION

I. HISTORY

On November 12, 2003, this Court entered a memorandum opinion and order denying Debtors' motion for entry of an order determining all reclamation claims to be general unsecured claims. *See In re Phar-Mor, Inc.*, ___ B.R. ___, 2003 Bankr. LEXIS 1478 (Bankr. N.D. Ohio Nov. 12, 2003). This Court determined that numerous vendors that supplied Debtors with various goods prior to and during bankruptcy asserted valid reclamation claims pursuant to § 546(c) of the Bankruptcy Code and § 2-702 of the Uniform Commercial Code ("Vendors").[1] This Court also found that the value of these claims was not affected by the interests of the Pre-Petition Lenders[2] because the Pre-Petition Lenders chose to release their security interests and were paid in full

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[1] Hereinafter the term "Vendors" refer to American Leather Specialities Corp., Paper Magic Group, Inc., Magco Incorporated, Bonne Bell, Inc., McKesson Corporation, Fleming Companies, Inc., Liquidity Solutions, Inc., Proctor & Gamble Distributing Corporation, Reckitt Benchiser, McCormick & Co., Wyeth Consumer Products, Master Foods USA, Pepsi-Cola Company, Checkpoint Systems, Inc., Hershey Foods Corporation, The Dial Corporation, Bayer Corporation, CCA Industries, Inc., Golden Valley Microwave Foods, Inc., Sara Lee Knit Products, Ross Products Division Abbott Laboratories, Inc., Gray & Company, Kimberly-Clark Corporation, Blueberry Confections, Inc., Union Wadding Company, Pfizer, Inc., Collegeware USA, Inc., Glaxo Smith Kline, and Unilever HPC USA.

[2] Hereinafter the term "Pre-Petition Lenders" refers to the lenders that entered into a loan and security agreement with Debtors dated as of Nov. 16, 2000.

through the Interim DIP order[3] and Final DIP order[4] entered by the Court on September 24, 2001 and October 23, 2001. This Court further found that those reclamation claims submitted prior to the entry of the Interim Order could not be defeated by the interests of the DIP Lenders because a debtor's decision to grant a security interest in inventory to a *subsequent* secured lender cannot defeat a seller's reclamation rights. Several of the Vendors, whose reclamation claims Debtors sought to relegate to the status of general unsecured claim, submitted valid reclamation claims prior to September 24, 2001. Thus, these reclamation claims could not be affected by or were not subject to the interests of the DIP Lenders. This Court overruled Debtors' motion since it sought an order determining each of the reclamation claims to be general unsecured claims.

On November 24, 2003 Debtors filed a motion for reconsideration of this Court's prior memorandum opinion and order overruling Debtors' motion. Debtors put forth two arguments as to why this Court should modify and alter its prior memorandum opinion and order overruling Debtors' motion. First, Debtors argue the value of a reclamation claim is established at the moment in time when the reclamation demand is received. Accordingly, Debtors argue the reclamation claims attributable to demands received prior to September 24, 2001 were of no value because the Vendors' goods were subject to the claims of the Pre-Petition Lenders. Second, Debtors argue reclamation

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[3] Interim DIP Order, Sept. 24, 2001, Doc. No. 13.

[4] Final DIP Order, Oct. 23, 2001, Doc. No. 148.

claims attributable to demands received on or after September 24, 2001 are of no value because the Vendors' goods were subject to the claims of the DIP Lenders. Accordingly, Debtors argue the reclamation claims of all Vendors should be relegated to the status of general unsecured claim.

II. ANALYSIS

A. Reclamation Demands Received Prior to September 24, 2001

This Court rejected Debtors' argument that the value of a reclamation claim is determined at the moment in time when the reclamation demand is received. To accept Debtors' argument would be tantamount to adopting the position that a seller's right to reclaim is automatically extinguished by the existing interest of a secured creditor. Nearly every court which has addressed this issue has found that a seller's right to reclaim is subject to the existing interest of a secured creditor, meaning that the right to reclaim is subordinate to the interest of a secured creditor and not automatically extinguished by such interest. *Id.* at *28 (citations omitted).

Outside of bankruptcy a reclaiming seller retains a priority interest in any surplus proceeds traceable to the goods when an existing secured creditor forecloses on such goods. *Pester Ref. Co. v. Ethyl Corp.* (*In re Pester Ref. Co.*), 964 F.2d 842, 846 (8th Cir. 1992). The *value* of a reclamation claim is not determined at the moment in time when the reclamation demand is received. *See Id.* at 847 (rejecting debtor's argument that reclamation claim is worthless because the secured creditors were undersecured at the outset

because argument "ignores the freedom of secured creditors in non-bankruptcy contexts to relinquish all or part of their security interests."). The Pre-Petition Lenders chose to release their security interests and were paid in full through the Interim and Final DIP Orders. Accordingly, the Vendors' reclamation claims were not rendered valueless because of the interests of the Pre-Petition Lenders.

B. Reclamation Demands Received on or After September 24, 2001

Debtors' second argument is that reclamation claims attributable to demands received on or after September 24, 2001 are of no value. Debtors argue these reclamation claims are valueless because the Vendors' goods were then subject to the claims of the DIP Lenders. Debtors effectively ask the Court to reconsider its decision as it concerns only those reclamation claims attributable to demands received on or after September 24, 2001.

This Court did not consider each reclamation claim Debtors sought to relegate to the status of a general unsecured claim on an individual basis. Debtors sought the entry of an order determining each of the reclamation claims to be general unsecured claims.[5]

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[5] The last page of Debtors' motion provides: "WHEREFORE, Debtors pray for an order determining that each of the claims of the Reclamation Claimants identified in the Reclamation Reports be allowed as a general unsecured claim only and that to the extent such Reclamation Claimants asserts a claim entitled to priority allowance, that such claim be denied, together with such other and further relief as to this Court seems proper." Debtors'

Debtors did not argue that only some of the reclamation claims should be allowed only as general unsecured claims. Accordingly, Debtors failed to direct this Court's attention to the part of the Reclamation Report[6] stating the date each reclamation demand was received. Debtors mistakenly thought that the Pre-Petition Lenders had assigned their interests to the DIP Lenders thereby making this case indistinguishable from this Court's prior decision in the *Wheeling-Pittsburgh* bankruptcy.[7] Unlike in *Wheeling-Pittsburgh*, however, the Pre-Petition Lenders in this case did not assign their security interests to the DIP Lenders.

Upon a closer examination of the Reclamation Report it is evident that some of the Vendors' reclamation claims are attributable to demands received on or after September 24, 2001. In its decision, this Court did not find that the reclamation claims received on or after September 24, 2001 were not subject to the interests of the DIP Lenders. This Court found that a debtor's decision to grant a security interest in inventory to a *subsequent* secured lender cannot defeat a seller's reclamation rights. The interests of the DIP Lenders, however, did not arise *subsequent* to the creation of these reclamation claims. This Court recognizes that a reclamation claim does not exist until a reclamation demand asserting such

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Motion Determining Reclamation Claims, p. 11, Feb. 13, 2003, Doc. No. 1539.

[6] Reclamation Report, Apr. 9, 2002, Doc. No. 601.

[7] *See In re Pittsburgh-Canfield Corp.*, Case No. 00-43394 (Bankr. N.D. Ohio Mar. 13, 2003).

claim is received. *See Flav-O-Rich, Inc. v. Rawson Food Serv., Inc.* (*In re Rawson Food Serv., Inc.*), 846 F.2d 1343, 1347-48 (11th Cir. 1988). Therefore, the reclamation claims attributable to demands received on or after September 24, 2001 were subject to the interests of the DIP Lenders.

At the hearing conducted on June 10, 2003, Debtors proffered the testimony of Martin S. Seekely, Debtors' Vice President and Chief Financial Officer, that the goods subject to reclamation demands were sold in satisfaction of the DIP Lenders' loan prior to the weak of July 20-27, 2002. Mr. Seekely was available for cross examination. As noted in this Court's decision, the DIP operating reports for July 2002 to January 2003 reveal that the DIP loan of One Hundred Thirty-Five Million Dollars ($135,000,000.00) was paid off by the week of July 20-27, 2002. Since the reclamation claims attributable to demands received on or after September 24, 2001 were subject to the interests of the DIP Lenders, and since the subject goods were in fact sold in satisfaction of the DIP Lenders' loan, these claims are of no reclamation value and should be allowed only as general unsecured claims.

CONCLUSION

For the reasons set forth in this Court's prior opinion, those reclamation claims attributable to demands received prior to September 24, 2001 should be granted an administrative priority pursuant to § 546(c). Those reclamation claims attributable to demands received on or after September 24, 2001, however, should be allowed only as general unsecured claims. This order amends this Court's December 16, 2003 order overruling Debtors' motion for

reconsideration of the Court's opinion overruling Debtors' motion for entry of an order determining all reclamation claims to be general unsecured claims. This order also amends this Court's November 12, 2003 memorandum opinion and order denying in full Debtors' motion for entry of an order determining each of the reclamation claims to be general unsecured claims. Debtors' motion is hereby granted in part and denied in part, consistent with this order.

IT IS SO ORDERED.

/s/William T. Bodoh
WILLIAM T. BODOH
UNITED STATES BANKRUPTCY JUDGE

APPENDIX D

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO

JOINTLY ADMINISTERED

No. 01-44007

[Filed December 16, 2003]

IN RE:	)
	)
PHAR-MOR, INC., *et al.*,	)
Debtors.	)
	)

ORDER

This cause is before the Court on the motion of Phar-Mor, Inc. and related entities ("Debtors") for reconsideration of this Court's prior memorandum opinion and order overruling Debtors' motion for entry of an order determining all reclamation claims to be general unsecured claims pursuant to 11 U.S.C. § 502(j) and FED. R. BANKR. P. 3008. The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157(b) and 1334(b).

DISCUSSION

I. HISTORY

On November 12, 2003, this Court entered a memorandum opinion and order denying Debtors' motion for entry of an order determining all reclamation claims to be general unsecured claims. *See In re Phar-Mor, Inc.*, ___ B.R. ___, 2003 Bankr. LEXIS 1478 (Bankr. N.D. Ohio Nov. 12, 2003). This Court determined that numerous vendors that supplied Debtors with various goods prior to and during bankruptcy asserted valid reclamation claims pursuant to § 546(c) of the Bankruptcy Code and § 2-702 of the Uniform Commercial Code ("Vendors").[1] This Court also found that the value of these claims was not affected by the interests of the Pre-Petition Lenders[2] because the Pre-Petition Lenders chose to release their security interests and were paid in full

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[1] Hereinafter the term "Vendors" refer to American Leather Specialities Corp., Paper Magic Group, Inc., Magco Incorporated, Bonne Bell, Inc., McKesson Corporation, Fleming Companies, Inc., Liquidity Solutions, Inc., Proctor & Gamble Distributing Corporation, Reckitt Benchiser, McCormick & Co., Wyeth Consumer Products, Master Foods USA, Pepsi-Cola Company, Checkpoint Systems, Inc., Hershey Foods Corporation, The Dial Corporation, Bayer Corporation, CCA Industries, Inc., Golden Valley Microwave Foods, Inc., Sara Lee Knit Products, Ross Products Division Abbott Laboratories, Inc., Gray & Company, Kimberly-Clark Corporation, Blueberry Confections, Inc., Union Wadding Company, Pfizer, Inc., Collegeware USA, Inc., Glaxo Smith Kline, and Unilever HPC USA.

[2] Hereinafter the term "Pre-Petition Lenders" refers to the lenders that entered into a loan and security agreement with Debtors dated as of Nov. 16, 2000.

through the Interim DIP order[3] and Final DIP order[4] entered by the Court on September 24, 2001 and October 23, 2001. This Court further found that those reclamation claims submitted prior to the entry of the Interim Order could not be defeated by the interests of the DIP Lenders because a debtor's decision to grant a security interest in inventory to a *subsequent* secured lender cannot defeat a seller's reclamation rights. Several of the Vendors, whose reclamation claims Debtors sought to relegate to the status of general unsecured claim, submitted valid reclamation claims prior to September 24, 2001. Thus, these reclamation claims could not be affected by or were not subject to the interests of the DIP Lenders. This Court overruled Debtors' motion since it sought an order determining each of the reclamation claims to be general unsecured claims.

On November 24, 2003 Debtors filed a motion for reconsideration of this Court's prior memorandum opinion and order overruling Debtors' motion. Debtors put forth two arguments as to why this Court should modify and alter its prior memorandum opinion and order overruling Debtors' motion. First, Debtors argue the value of a reclamation claim is established at the moment in time when the reclamation demand is received. Accordingly, Debtors argue the reclamation claims attributable to demands received prior to September 24, 2001 were of no value because the Vendors' goods were subject to the claims of the Pre-Petition Lenders. Second, Debtors argue reclamation

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[3] Interim DIP Order, Sept . 24, 2001, Doc. No. 13.

[4] Final DIP Order, Oct. 23, 2001, Doc. No. 148.

claims attributable to demands received on or after September 24, 2001 are of no value because the Vendors' goods were subject to the claims of the DIP Lenders. Accordingly, Debtors argue the reclamation claims of all Vendors should be relegated to the status of general unsecured claim.

II. ANALYSIS

A. Reclamation Demands Received Prior to September 24, 2001

This Court rejected Debtors' argument that the value of a reclamation claim is determined at the moment in time when the reclamation demand is received. To accept Debtors' argument would be tantamount to adopting the position that a seller's right to reclaim is automatically extinguished by the existing interest of a secured creditor. Nearly every court which has addressed this issue has found that a seller's right to reclaim is subject to the existing interest of a secured creditor, meaning that the right to reclaim is subordinate to the interest of a secured creditor and not automatically extinguished by such interest. *Id.* at *28 (citations omitted).

Outside of bankruptcy a reclaiming seller retains a priority interest in any surplus proceeds traceable to the goods when an existing secured creditor forecloses on such goods. *Pester Ref. Co. v. Ethyl Corp.* (*In re Pester Ref. Co.*), 964 F.2d 842, 846 (8th Cir. 1992). The value of a reclamation claim is not determined at the moment in time when the reclamation demand is received. *See Id.* at 847 (rejecting debtor's argument that reclamation claim is worthless because the secured creditors were undersecured at the outset

because argument "ignores the freedom of secured creditors in non-bankruptcy contexts to relinquish all or part of their security interests."). The Pre-Petition Lenders chose to release their security interests and were paid in full through the Interim and Final DIP Orders. Accordingly, the Vendors' reclamation claims were not rendered valueless because of the interests of the Pre-Petition Lenders.

B. Reclamation Demands Received on or After September 24, 2001

Debtors' second argument is that reclamation claims attributable to demands received on or after September 24, 2001 are of no value. Debtors argue these reclamation claims are valueless because the Vendors' goods were then subject to the claims of the DIP Lenders. Debtors effectively ask the Court to reconsider its decision as it concerns only those reclamation claims attributable to demands received on or after September 24, 2001.

This Court did not consider each reclamation claim Debtors sought to relegate to the status of a general unsecured claim on an individual basis. Debtors sought the entry of an order determining each of the reclamation claims to be general unsecured claims.[5]

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[5] The last page of Debtors' motion provides: "WHEREFORE, Debtors pray for an order determining that each of the claims of the Reclamation Claimants identified in the Reclamation Reports be allowed as a general unsecured claim only and that to the extent such Reclamation Claimants asserts a claim entitled to priority allowance, that such claim be denied, together with such other and further relief as to this Court seems proper." Debtors'

Debtors did not argue that only some of the reclamation claims should be allowed only as general unsecured claims. Accordingly, Debtors failed to direct this Court's attention to the part of the Reclamation Report[6] stating the date each reclamation demand was received. Debtors mistakenly thought that the Pre-Petition Lenders had assigned their interests to the DIP Lenders thereby making this case indistinguishable from this Court's prior decision in the *Wheeling-Pittsburgh* bankruptcy.[7] Unlike in *Wheeling-Pittsburgh*, however, the Pre-Petition Lenders in this case did not assign their security interests to the DIP Lenders.

Upon a closer examination of the Reclamation Report it is evident that some of the Vendors' reclamation claims are attributable to demands received on or after September 24, 2001. In its decision, this Court did not find that the reclamation claims received on or after September 24, 2001 were not subject to the interests of the DIP Lenders. This Court found that a debtor's decision to grant a security interest in inventory to a *subsequent* secured lender cannot defeat a seller's reclamation rights. The interests of the DIP Lenders, however, did not arise *subsequent* to the creation of these reclamation claims. This Court recognizes that a reclamation claim does not exist until a reclamation demand asserting such

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Motion Determining Reclamation Claims, p. 11, Feb. 13, 2003, Doc. No. 1539.

[6] Reclamation Report, Apr. 9, 2002, Doc. No. 601.

[7] *See In re Pittsburgh-Canfield Corp.*, Case No. 00-43394 (Bankr. N.D. Ohio Mar. 13, 2003).

claim is received. *See Flav-O-Rich, Inc. v. Rawson Food Serv., Inc.* (*In re Rawson Food Serv., Inc.*), 846 F.2d 1343, 1347-48 (11th Cir. 1988). Therefore, the reclamation claims attributable to demands received on or after September 24, 2001 were subject to the interests of the DIP Lenders.

Debtors argue that this conclusion necessitates a finding that the reclamation claims attributable to demands received on or after September 24, 2001 are of no value because the DIP Lenders were paid in full through Debtors' going-out-of-business sales. Debtors, however, failed to introduce evidence demonstrating that the goods subject to these reclamation claims were in fact sold in satisfaction of the interests of the DIP Lenders.[8] Evidence that the DIP Lenders were satisfied from the proceeds of some or most of Debtors' inventory is not evidence that the DIP Lenders were satisfied from the proceeds of the goods subject to the reclamation claims arising from demands received on or after September 24, 2001.[9] While it may be that

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[8] As noted in this Court's decision, the DIP operating reports for July 2002 to January 2003 reveal that the DIP loan of One Hundred Thirty-Five Million Dollars ($135,000,000.00) was paid off by the weak of July 20-27, 2002. The DIP operating reports also reveal that from August 2002 to January 2003 Debtors received approximately One Hundred Fifty-Four Million Four Hundred Eighty-Three Thousand Twenty Dollars ($154,483,020.00). It is possible that some of the goods subject to the reclamation claims attributable to demands received on or after September 24, 2001 were sold after the DIP loan was paid off.

[9] The debtors in *Wheeling-Pittsburgh* proffered the testimony of debtors' director of internal audit for the proposition that the goods *subject to the reclamation demands* made by the objecting

goods subject to these reclamation claims were sold in satisfaction of the interests of the DIP Lenders, this Court may only consider the evidence already in the record when considering a motion to reconsider. Based on the evidence already in the record, there is not a sufficient basis upon which to partially grant Debtors the relief they seek and declare that those reclamation claims attributable to demands received on or after September 24, 2001 should be allowed only as general unsecured claims.

CONCLUSION

For the reasons set forth in this Court's prior decision, those reclamation claims attributable to demands received prior to September 24, 2001 should be granted an administrative priority pursuant to § 546(c). Those reclamation claims attributable to demands received on or after September 24, 2001 are subject to the prior interests of the DIP Lenders. However, the record as it stands does not support the entry of an order relegating these reclamation claims to the status of a general unsecured claim. Accordingly, Debtors' motion for reconsideration is overruled.

IT IS SO ORDERED.

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vendors had in fact been consumed and all proceeds of such goods had been automatically paid to the lenders under the DIP facility. The Debtors in the case *sub judice*, however, failed to introduce this type of evidence.

/s/William T. Bodoh
WILLIAM T. BODOH
UNITED STATES BANKRUPTCY JUDGE

APPENDIX E

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT O F OHIO

JOINTLY ADMINISTERED

No. 01-44007

[Filed November 12, 2003]

IN RE:	)
	)
PHAR-MOR, INC., et *al.*,	)
Debtors.	)
	)

MEMORANDUM OPINION

This cause is before the Court on the motion of Phar-Mor, Inc. and affiliated debtors (collectively, the "Debtors") for entry of an order determining reclamation claims to be general unsecured claims and objection to allowance of such claims as entitled to priority. American Leather Specialities Corp., Paper Magic Group, Inc., Magco Incorporated, Bonne Bell, Inc., McKesson Corporation, Fleming Companies, Inc., Liquidity Solutions, Inc., Proctor & Gamble Distributing Corporation, Reckitt Benchiser, McCormick & Co., Wyeth Consumer Products, Master Foods USA, Pepsi-Cola Company, Checkpoint Systems, Inc., Hershey Foods Corporation, The Dial Corporation, Bayer Corporation, CCA Industries, Inc.,

Golden Valley Microwave Foods, Inc., Sara Lee Knit Products, Ross Products Division Abbott Laboratories, Inc., Gray & Company, Kimberly-Clark Corporation, Blueberry Confections, Inc., Union Wadding Company, Pfizer, Inc., Collegeware USA, Inc., Glaxo Smith Kline, and Unilever HPC USA (collectively the "Vendors") have filed objections to Debtors' motion for entry of an order determining reclamation claims to be general unsecured claims and allowance of such claims as entitled to priority. The Bank of New York has filed a joinder to Debtors' motion and objection. A hearing was held on this matter on June 10, 2003. This Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157(b) and 1334(b). The following represents this Court's findings of fact and conclusions of law pursuant to FED. R. BANKR. P. 7052.

DISCUSSION

I. FACTS

On September 24, 2001, Debtors filed their voluntary petitions for relief under Chapter 11 of the United States Bankruptcy Code. Debtors continue to operate their businesses and manage their assets as Debtors-in-Possession pursuant to §§ 1107 and 1108 of the Bankruptcy Code. Prior to the petition date, in the ordinary course of their businesses, Debtors purchased and received goods from various suppliers for use in the operation of their deep discount drug store chain. Both before and after the petition date, Debtors received reclamation demands from Vendors claiming rights of reclamation pursuant to applicable state law and § 546(c) of the United States Bankruptcy Code (the "Reclamation Demands").

On October 5, 2001, 11 days after Debtors' cases commenced, Debtors served and filed a notice of hearing upon Debtors' motion for an order (A) prohibiting third parties from interfering with Debtors' receipt, use or disposition of goods, and (B) establishing procedures for the liquidation and treatment of reclamation claims ("Reclamation Procedures Motion"). Debtors stated in their Reclamation Procedures Motion that:

> Under state law, as made applicable to these proceedings by Section 546(c) of the Bankruptcy Code, certain of the Vendors may have the right to reclaim goods sold to the Debtors prior to the Filing Date. However, as of the date hereof, the goods for which Reclamation Demands have been made have either been incorporated into the Debtors' preexisting inventory or have been sold in the ordinary course of the Debtors' business operations. Thus, it would be either impossible or impractical to segregate and return such goods at this time.
>
> Debtors have determined that it is in the best interests of their estates to implement a consensual procedure for the liquidation and treatment of the Reclamation Demands, and for the resolution of disputes as to the specifics of individual Reclamation Demands. Such a procedure would avoid, in large part, the expensive and burdensome litigation necessarily attendant with defending reclamation claims.

RELIEF REQUESTED

Pursuant to Section 546(c)(2) of the Bankruptcy Code, the Court may deny reclamation to a Vendor with a valid and enforceable right of reclamation only if it: (i) grants the claim of such Vendor an administrative expense priority; or (ii) secures the claim by a lien. Most, if not all, of the goods for which Reclamation Demands have been made have either been sold in the daily operation of the Debtor's [sic] retail operations or integrated into the Debtors' inventories, such that identification of specific goods is not feasible. In addition, the granting of liens to reclamation claimants could violate the agreements governing the Debtors' post-petition financing arrangements. Accordingly, granting liens on such goods would be impractical, and in most cases, impossible.

Consequently, the Debtors propose that each Vendor be granted an administrative expense priority claim under Section 503(b) in the amount (if any) of its allowed reclamation claim, with the amount of such allowed reclamation claim to be subject to the resolution of all of the various defenses set forth above. The Debtors also request that the Court, pursuant to Section 546(c)(2)(A) of the Bankruptcy Code, approve the following procedures for the determination of the allowed amount of each Vendor's reclamation claim.

Following the determination of all of the Vendors' Reclamation Claim Amounts, in accordance with the foregoing procedures, the

> Debtors may commence further proceedings to determine the extent to which the Reclamation Claim Amounts are subject to further defenses by reason of liens granted to the Debtors' secured creditors. In the alternative, the Debtors may propose to resolve such issues through a proposed plan of reorganization that specifies the extent to which the Reclamation Claims shall be treated as allowed administrative expense priority claims.

(Reclamation Procedures Motion ¶¶ 8, 10-12, Oct. 5, 2001, Doc. No. 71.) The proposed procedure required each reclaiming seller to provide additional information to Debtors regarding its reclamation claim within 30 days. (*Id.* at ¶ 12(a).) Once that information was provided to Debtors, Debtors then had 90 days to file and serve on each of the reclaiming creditors their own report setting forth the value of the reclamation claims as determined by Debtors. (*Id.* at ¶ 12(b).) Once Debtors' report was filed and served, each reclaiming seller then had 20 days to object to the report. (*Id.* at ¶ 12(c).) The proposed procedure did not purport to adjudicate any of the substantive rights of the reclamation creditors. Debtors sought to defer the resolution of the reclamation claimants' statutory rights to assert administrative claims or liens as provided under § 546(c) of the United States Bankruptcy Code.

On January 9, 2002, the Court granted the Reclamation Procedures Motion and entered the order (A) prohibiting third parties from interfering with Debtors' receipt, use or disposition of goods and (B) establishing procedures for the liquidation and treatment of reclamation claims ("Reclamation

Procedures Order"). The Reclamation Procedures Order adopts the procedure for dealing with the Reclamation Demands set forth in Debtors' Reclamation Procedures Motion in that it gave Vendors 30 days to provide additional information to Debtors regarding their reclamation claims and Debtors 90 days thereafter to file and serve on each of the reclaiming creditors their own report setting forth the value of the reclamation claims as determined by Debtors. (Reclamation Procedures Order 1-2, Jan. 9, 2002, Doc. No. 383.)

The Reclamation Procedures Order also provides that after the factual disputes were resolved and the amount of the reclamation claims determined, Debtors would either "commence further proceedings to determine the extent to which the Reclamation Claim Amounts are subject to further defenses by reason of liens granted to the Debtors' secured creditors," or alternatively, "propose to resolve such issues through a proposed plan of reorganization that specifies the extent to which the Reclamation Claims shall be treated as allowed administrative expense priority claims." (*Id.* at 3.) The Reclamation Procedures Order further provides:

> The foregoing procedures shall constitute the Vendors' sole remedies with respect to their Reclamation Demands. Vendors shall not be required to initiate adversary proceedings or to take any procedural steps (other than those set forth herein) in order to preserve or perfect their Reclamation Demands. Vendors and other third parties are also prohibited and enjoined

> from interfering with the Debtors' receipt, use or disposition of goods.

(*Id.* at 4.)

Pursuant to the Reclamation Procedures Order, Vendors filed reclamation claim reports which set forth the values of the goods that were the subject of the Reclamation Demands filed before and after the petition date. On April 9, 2002, Debtors filed their reclamation claim report (the "Report"). The Report provides a detailed analysis of the approximately 141 reclamation claims asserted against Debtors, with an asserted value of Eighteen Million Four Hundred Fifty Thousand Forty-Five and 39/100 Dollars ($18,450,045.39). (Report ¶ 6, Apr. 9, 2002, Doc. No. 601.) The Report contains information regarding the dates the Reclamation Demands were received, the asserted amount of the Reclamation Demands, the value of the products received, the estimated value of the products in the possession of Debtors at the date the Reclamation Demands were received and Debtors' recommended reclamation amount for each Vendor. The Report provides there is no basis to deny some of the reclamation claims Debtors now seek to have relegated to the status of general unsecured claims.[1]

Prior to filing for bankruptcy, Debtors entered into a loan and security agreement ("Pre-Petition Credit

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[1] Exhibit A, which is attached to the Report, uses a numbering scheme to indicate the basis Debtors maintain some of the reclamation claims should be denied. The absence of numbers in some of the "Basis for Disallowance" spaces indicates there is no basis to deny some of the reclamation claims Debtors seek to relegate to the status of general unsecured credits in their motion.

Agreement") dated as of November 16, 2000 with certain financial institutions ("Pre- Petition Lenders") and Fleet Retail Finance, Inc. as agent ("Agent"). The loans made pursuant to the Pre-Petition Credit Agreement were secured by substantially all of Debtors' assets including, but not limited to, accounts, inventory, general intangibles, goods, fixtures, chattel paper, money, cash, or cash equivalents relating thereto, proceeds, excessions, substitutions, replacements, rents, profits, and products of the aforementioned property. On the petition date, Debtors were liable to Pre-Petition Lenders in the principal amount of One Hundred Three Million Five Hundred Ten Thousand Dollars ($103,510,000.00).[2] No portion of this pre-petition debt was listed in Debtors' schedules as being unsecured. (Debtors' Statement of Financial Affairs and Schedules of Assets and Liabilities, Nov. 21, 2001, Doc. No. 264.)

On the petition date, Debtors moved for approval of a *debtor-in-possession* credit facility (the "DIP

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[2] Page 4 of the Final DIP Order provides:

> Prior to the Petition Date, the Debtors entered into the Pre-Petition Loan Agreement, pursuant to which the Pre-Petition Lenders extended a working capital facility providing for revolving credit loans and letters of credit. The Debtors stipulate and agree that as of the Petition Date, the Debtors were indebted to the Pre-Petition Lenders in the approximate principal sum (including amounts available to be drawn under outstanding pre-petition letters of credit) of $103,510,000.00, plus accruedinterest, costs, fees, andprofessional fees and expenses, and all other Liabilities as defined in the Pre-Petition Loan Agreement (collectively, hereinafter the **"Pre-Petition Obligations"**).

Facility"). This Court entered an interim order approving the DIP Facility on September 24, 2001 ("Interim DIP Order"). On October 23, 2001, this Court entered a final order approving the DIP Facility ("Final DIP Order"). The Final DIP Order authorized Debtors to borrow up to One Hundred Thirty-Five Million Dollars ($135,000,000.00) and included provisions that related to the Pre-Petition Credit Agreement. (Final DIP Order 5 ¶ 2(c), Oct . 23, 2001, Doc. No. 148.) Under the Interim and Final DIP Orders Debtors were authorized to, and did in fact, repay all obligations owed to Pre-Petition Lenders under the Pre-Petition Credit Agreement.[3] These payments were ratified and confirmed in the Final DIP Order.

Upon receipt by Pre-Petition Lenders of all amounts owed to them under the Pre-Petition Credit Agreement, any liens or security interests granted in favor of Pre-Petition Lenders securing the pre- petition obligations on any asset of Debtors or otherwise were

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[3] Indeed Page 20 of the Disclosure Statement filed on January 23, 2003 provides:

> On the Commencement Date, the Debtors secured a $135 million Debtor-In-Possession Revolving Credit Facility (the "DIP Credit Facility") financing through Fleet, which was used to satisfy the Fleet Pre-Filing Indebtedness and to fund the Debtors' operations through its attempted reorganization process. Pursuant to an Order dated October 23, 2001, the Bankruptcy Court approved the DIP Credit Facility.

deemed released, terminated and extinguished.[4] The Final DIP Order did not assign and transfer from Pre-Petition Lenders to the lenders under the DIP Facility ("DIP Lenders") the pre-petition liens and security interests that secured the obligations arising under the Pre-Petition Credit Agreement. Instead, the Final DIP Order gave Debtors the authority to grant DIP Lenders new liens with priority over any other security, mortgage, collateral interest or lien on all of Debtors property.[5] The liabilities under the DIP loan

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[4] Paragraph 8 on Page 6 of the Final DIP Order provides:

> subject only to Paragraph 9 of this Order, the Debtors on behalf of themselves and their estates and their successors, including any subsequently appointed Trustee hereby: (i) release and discharge the Pre-Petition Agent and the Pre-Petition Lenders together with their affiliates, agents, attorneys, officers, directors and employees from any and all claims and cause of action arising out of, based upon or related to the Pre-Petition Loan Agreement; (ii) waive any and all defenses (including, without limitation, offsets and counterclaims of any nature or kind) as to the validity, perfection, priority, enforceability, and avoidability (under sections 510, 544, 545, 547, 548, 550, 552 or 553 of the Bankruptcy Code or otherwise) or the Pre-Petition Obligations or the security interests and liens granted to secure Pre-Petition Obligations, and (iii) agrees, without further Court order, to the allowance of the pre-petition claims of the Pre-Petition Agent and the Pre-Petition Lenders as fully secured in an amount not less than the Pre-Petition Obligations pursuant to sections 502 and 506 of the Bankruptcy Code.

[5] Paragraph 10 on Page 7 of the Final DIP Order provides: " The Liens to be created and granted to the Agent, as provided herein, are created pursuant to Bankruptcy Code Sections 364(c)(2), 364(c)(3) and 364(d)." (emphasis added).

were also granted the status of super-priority claim over all allowed administrative expense claims. (*Id.* at 8 ¶ 14.)

The Final DIP Order addressed the rights of the reclamation creditors. The Final DIP Order provided the post-petition liabilities under the DIP Facility would have priority over all reclamation claims under § 546(c). The Final DIP Order provides:

> The Liabilities under the Loan Agreement shall be an allowed administrative expense claim (the "**Super-priority** Claim") with priority (except as otherwise provided in Paragraph 16 below) under Bankruptcy Code Section 364(c)(1) and otherwise over all administrative expense claims and unsecured claims against the Debtors, now existing or hereafter arising, of any kind or nature whatsoever including, without limitation, administrative expenses of the kinds specified in or ordered pursuant to Bankruptcy Code Section 105, 326, 330 (except as otherwise provided in Paragraph 16, below), 331, 503(a), 503(b), 507(a), 507(b), **546(c)**, and 1114.

(*Id.* (emphasis added).) The Final DIP Order also prohibits Debtors from returning the goods constituting collateral under § 546(c) or 546(g) of the Bankruptcy Code. (*Id.* at 10 ¶ 17(c).) Nothing in the Final DIP Order prohibited granting reclamation claimants an administrative priority claim that was junior to any such claim held by DIP Lenders.

After the commencement of Debtors' Chapter 11 cases, Debtors determined it was in the best interests

of the estates to eliminate and terminate operations at 65 of their non-core retail stores. On October 9, 2001, Debtors held an auction in order to solicit bids related to the sale of inventory, furniture, fixtures and equipment located at the 65 locations. Debtors ultimately entered into an agency agreement with a joint venture comprised of Hilco Merchant Resources, LLC and The Ozer Group, LLC (collectively, the "GOB Agent") regarding the termination of operations at the 65 retail stores. On October 10, 2001, the Court entered an order authorizing Debtors to sell their assets by conducting "going-out-of-business" sales ("GOB I Sales") at the 65 locations. The Debtors received approximately Thirty Million Six Hundred Thirty Thousand Dollars ($30,630,000.00) in proceeds from the GOB I Sales. (Disclosure Statement 22, Jan. 23, 2003, Doc. No. 1495.) Pursuant to the agency agreement, these proceeds were deposited into an account established by the GOB Agent.

Despite Debtors' efforts to reduce costs and expenses, Debtors continued to suffer operating losses. Based on these losses, Debtors decided to direct their efforts toward effecting an orderly wind-down of their operations. Debtors solicited offers from the liquidation of their inventory through additional "going-out-of-business" sales. On July 3, 2002, Debtors filed a motion with the Court seeking authority to sell substantially all of their remaining assets and to conduct any associated "going-out-of-business" sales. On July 18, 2002, the Court entered an order authorizing Debtors to sell substantially all of their assets by conducting "going-out-of-business" sales ("GOB II Sales"). Debtors executed a second agency agreement with GOB Agent and commenced the sale of substantially all of their assets. Debtors received

approximately One Hundred Three Million Seven Hundred Ninety-Three Thousand Dollars ($103,793,000.00) in proceeds from the GOB II Sales. (*Id.*)

The DIP operating reports for July 2002 to January 2003 reveal that the DIP loan of One Hundred Thirty-Five Million Dollars ($135,000,000.00) was paid off by the week of July 20-27, 2002. The DIP operating reports also reveal that from August 2002 to January 2003 Debtors received approximately One Hundred Fifty-Four Million Four Hundred Eighty-Three Thousand Twenty Dollars ($154,483,020.00). Some of these revenues, undoubtedly, were used to fund the costs of the liquidation or sale of substantially all of Debtors' assets.

On January 23, 2003, Debtors filed their disclosure statement pursuant to § 1125 of the Bankruptcy Code for first amended joint plan of liquidation dated January 23, 2003, proposed jointly by Debtors and the Official Committee of Unsecured Creditors ("Disclosure Statement"). The Disclosure Statement provides both Pre-Petition Lenders and DIP Lenders have been paid in full. The Disclosure Statement confirms that the Pre-Petition Lenders were paid in full pursuant to the Interim DIP Order from the DIP Facility. (*Id.* at 20.) The Disclosure Statement also confirms that DIP Lenders were paid in full through the proceeds of GOB I Sales and GOB II Sales. According to the Disclosure Statement:

> From the GOB Sales Proceeds, the Debtors have paid in full the amounts owed to Fleet pursuant to the DIP Credit Facility. The Fleet obligation on September 24, 2001 (prior to GOB I Sales)

> was $91,777,000 and on July 19, 2002 (prior to GOB II Sales) was $35,489,000. In addition, the Debtors have repaid substantially all of the obligations they incurred during the operations of their businesses as Debtors in Possession in the ordinary course of their business affairs.

(*Id.* at 22.) The Disclosure Statement also provides for the payment of reclamation claims as administrative expenses.[6]

Debtors' monthly operating report as of November 30, 2002 reflects that cash in the amount of Fifty-Six Million Dollars ($56,000,000.00) is on hand and that the value of the significant remaining assets of Debtors (primarily consisting of deposits, accounts receivable and certain prepaid expenses) is approximately Eight Million Five Hundred Thousand Dollars ($8,500,000.00). The total funds to be distributed as of November 30, 2002 total Sixty-Four Million Five Hundred Thousand Dollars ($64,500,000.00). Thirty Million Three Hundred Thousand Dollars ($30,300,000.00) is allotted toward the payment of general unsecured claims, which total One Hundred Eighty-Five Million Five Hundred Thousand Dollars ($185,500,000.00). This distribution, however, explicitly excludes consideration of any

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[6] Page 12 of the Disclosure Statement allots Ten Million Dollars ($10,000,000.00) for the payment of reclamation claims. Reclamation claims are listed under the heading "Administrative" along with Accrued Reorganization Fees, McKesson, Inc. Administrative Obligations Per Court Order, Post-Petition Obligations, Employee Administrative Claims Per Court Order, and Projected Operating Expenses and Professional Fees to Conclusion of Case.

proceeds which may be received from causes of action described in the Disclosure Statement.

On February 13, 2003, Debtors filed a motion seeking the entry of an order determining reclamation claims to be general unsecured claims. Debtors object to the allowance of reclamation claims as entitled to priority. Debtors maintain that all of the goods that were subject to Vendors' Reclamation Demands have been sold, and the proceeds thereof have been automatically applied to repay Debtors' obligations under the DIP Facility. Debtors further assert that Debtors' inventory was the subject of valid pre-petition liens that were preserved to Agent under the DIP Facility. Accordingly, Debtors argue that all Vendors' reclamation claims are "subject to" the prior claims of the lenders under the DIP Facility, and as such are not entitled to administrative expense priority or to a replacement lien under § 546(c)(2) because, as previously stated, the proceeds generated by the sale of goods subject to Vendors' Reclamation Demands have been applied to Debtors' obligations under the DIP Facility. Debtors maintain that the DIP Facility has taken the entire value of the goods subject to the reclamation claims, thereby rendering Vendors' administrative expense claims worthless.

Vendors' objections to Debtors' motion are legion. First, numerous Vendors argue that since they have satisfied all the tests to assert their right to reclamation under the Bankruptcy Code and state law, they are automatically entitled to either an administrative priority or a replacement lien securing the full amount of their claims under 11 U.S.C. § 546(c). Second, Vendors argue that while the goods sought to be reclaimed were subject to Pre-Petition

Lenders' security interests, Pre-Petition Lenders were over-secured on the date of petition and were paid in full from the proceeds of the DIP Facility. Accordingly, Vendors argue Pre-Petition Lenders' security interests have not rendered Vendors' claims valueless. Third, Vendors argue that Debtors are estopped from arguing against the allowance of their reclamation claims by this Court's prior orders. The Reclamation Procedures Order enjoined Vendors from recovering their goods. Accordingly, it would be inequitable to permit Debtors to use the consumption of the goods Vendors were enjoined from recovering as a defense to the reclamation claims themselves. Moreover, the Disclosure Statement contains a representation that the reclamation claims are included as administrative expenses. Fourth, Vendors argue Debtors have failed to prove the goods were in fact sold and that all the sale proceeds were remitted to DIP Lenders. Fifth, Vendors argue that they are entitled to marshaling because there was a sufficient amount of non-inventory collateral from which Pre-Petition Lenders and DIP Lenders could satisfy their claims. Sixth, Vendors argue Debtors are attempting to assert rights, viz the rights of Pre-Petition and DIP Lenders, that they do not have under the Bankruptcy Code. Finally, Vendors argue Debtors' motion should be denied because it is procedurally defective, and that the relief Debtors seek requires an adversary proceeding pursuant to Rule 7001 of the Federal Rules of Bankruptcy Procedure.

II. LEGAL ANALYSIS

According to the Supreme Court, an interpretation of the Bankruptcy Code, as with all statutes, begins with the statutory language itself. *Barnhart v. Sigmon*

Coal Co., Inc., 534 U.S. 438, 450 (2002). Where the statute is plain, "the sole function of the courts is to enforce it according to its terms." *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989) (quotation omitted). The plain meaning of legislation should be conclusive, except when "the literal application of a statute will produce a result demonstrably at odds with the intentions of its drafters[.]" *Id.* at 242 (quoting *Griffin v. Oceanic Contractors, Inc.*, 458 U.S. 564, 571 (1982)); *see Koenig Sporting Goods, Inc. v. Morse Road Co. (In re Koenig Sporting Goods, Inc.)*, 203 F.3d 986, 988 (6th Cir. 2000) (stating "[i]f the statutory language is unambiguous, in the absence of a clearly expressed legislative intent to the contrary, that language must ordinarily be regarded as conclusive") (quotation omitted). Accordingly, this Court's analysis must begin with the language of 11 U.S.C. § 546(c).

A. Section 546(c) and Section 2-702

Section 546(c) of the Bankruptcy Code preserves a seller's right to reclaim goods under state law upon discovery of a debtor's insolvency. Section 546(c) provides:

> Except as provided in subsection (d) of this section, the rights and powers of a trustee under sections 544(a), 545, 547, and 549 of this title are subject to any statutory or common-law right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, but--

> (1) such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods--
>
> (A) before 10 days after receipt of such goods by the debtor; or
>
> (B) if such 10-day period expires after the commencement of the case, before 20 days after receipt of such goods by the debtor; and
>
> (2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court--
>
> (A) grants the claim of such a seller priority as a claim of a kind specified in section 503(b) of this title [an administrative expense priority]; or
>
> (B) secures such claim by a lien.

11 U.S.C. § 546(c). Thus, in order to establish a right to reclaim goods from a debtor pursuant to § 546(c), a reclaiming seller must establish: (1) a statutory or common law right to reclaim the goods; the goods were sold in the ordinary course of business; (3) the debtor's insolvency when it received the goods; (4) a written reclamation demand made within 10 days after debtor's receipt of the goods and (5) debtor's possession of the goods at the time the written reclamation demand was received. *See McLouth Steel Prods. Corp. v. Quaker Chem. Co.* (*In re McLouth Steel Prods. Corp.*), 213 B.R. 978, 984 (Bankr. E.D. Mich. 1997); 5 LAWRENCE P. KING ET AL., COLLIER ON BANKRUPTCY ¶ 546.04 (15th ed. 2003). Accordingly, Vendors must

first establish a statutory or common law right to reclaim the goods. *See Pester Ref. Co. v. Ethyl Corp.* (*In re Pester Ref. Co.*), 964 F.2d 842, 847 (8th Cir. 1992); *Galey & Lord Inc. v. Arley Corp.* (*In re Arlco, Inc.*), 239 B.R. 261, 266 (Bankr. S.D.N.Y. 1999); *Mitsubishi Consumer Elecs. Am., Inc. v. Steinberg's, Inc.* (*In re Steinberg's, Inc.*), 226 B.R. 8, 10 (Bankr. S.D. Ohio 1998); *In re Victory Mkts. Inc.*, 212 B.R. 738, 741 (Bankr. N.D.N.Y. 1997).

Virtually every state grants a seller the right to reclaim the goods it ships to an insolvent buyer under its version § 2-702 of the Uniform Commercial Code. Under § 2-702 of the Uniform Commercial Code:

> (A) Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under section 1302.79 of the Revised Code [§ 2-705 of the Uniform Commercial Code].
>
> (B) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this division the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

> (C) The seller's right to reclaim under division (B) of this section is subject to the rights of a buyer in ordinary course or other good faith purchaser or lien creditor under section 1302.44 of the Revised Code [§ 2-403 of the Uniform Commercial Code]. Successful reclamation of goods excludes all other remedies with respect to them.

OHIO REV. CODE ANN. § 1302.76 (Anderson 2002). Thus, under § 2-702 of the Uniform Commercial Code the seller must demonstrate that (1) the buyer received the goods while insolvent and (2) demand was made within 10 days after receipt, provided misrepresentation of solvency was not made in writing within three months before delivery. The remedy available to a seller that discovers the buyer has received goods on credit while insolvent is grounded in the theory that the reclaiming seller has been defrauded by the insolvent buyer's implicit representations of solvency. *See Pester Ref. Co.*, 964 F.2d at 844.

Numerous Vendors whose rights would be affected if Debtors' motion was granted have established a right to reclaim their goods under state law and have complied with the procedural requirements set forth in § 546(c)(1). It cannot seriously be argued that Debtors were solvent when they received the subject goods. Numerous Vendors diligently asserted their rights of reclamation by filing within the 10-day period a written reclamation demand. Moreover, Debtors were in possession of the subject goods at the time such written demands were received and the goods were sold in the ordinary course of business. Vendors also

complied with the Reclamation Procedures Order proposed by Debtors and entered by this Court.

Accordingly, Debtors seek to relegate to the status of general unsecured claim the claims of Vendors who properly asserted valid Reclamation Demands in accordance with state law, the Code and this Court's Reclamation Procedures Order. Debtors assert the Reclamation Procedures Order gives Debtors the right to so affect Vendors' claims because the Reclamation Procedures Order gives Debtors the right to "commence further proceedings to determine the extent to which the Reclamation Claim Amounts are subject to further defenses by reason of the liens granted to the Debtors' secured creditors." (Reclamation Procedures Order 3, Jan. 9, 2002, Doc. No. 383.) Thus, Debtors ask this Court to consider whether Vendors' reclamation claims were extinguished or are without value on account of the liens granted to Debtors' secured creditors.

B. Reclamation Rights Subject to Rights of Good Faith Purchaser

Section 2-702(C) of the Uniform Commercial Code provides that a seller's right to reclaim is "subject to" the rights of a buyer in the ordinary course or a good faith purchaser. OHIO REV. CODE ANN. § 1302.76(C); *see Pester Ref. Co.*, 964 F.2d at 844. It is well established that a secured creditor qualifies as a good faith purchaser for purposes of § 2-702(C). *Allegiance Healthcare Corp. v. Primary Health Sys., Inc. (In re Primary Health Sys., Inc.)*, 258 B.R. 111, 114 (Bankr. D. Del. 2001); *Steinberg's, Inc.*, 226 B.R. at 10; *In re Marko Elecs., Inc.*, 145 B.R. 25, 28 (Bankr. N.D. Ohio 1992); *Ohio Farmers Grain & Supply Ass'n v. Melvin*

Liquid Fertilizer Co., Inc. (In re Melvin Liquid Fertilizer Co., Inc.), 37 B.R. 587, 589 (Bankr. S.D. Ohio 1984); *U.S. Billiards Co., Inc. v. Greenberqe (In re Bensar Co.)*, 36 B.R. 699, 703 (Bankr. S.D. Ohio 1984); *Action Indus., Inc. v. Dixie Enters., Inc. (In re Dixie Enters., Inc.)*, 22 B.R. 855, 859 (Bankr. S.D. Ohio 1982). It is also well established that a seller's right to reclaim is "subject to" the existing interest of a secured creditor, meaning the right to reclaim is subordinate to the interest of a secured creditor and not automatically extinguished by such interest. *Pester Ref. Co.*, 964 F.2d at 846; *United States v. Westside Bank*, 732 F.2d 1258, 1262 (5th Cir. 1984); *Bindley W. Indus. v. Reliable Drug Stores, Inc. (In re Reliable Drug Stores, Inc.)*, 181 B.R. 374, 377 (S.D. Ind. 1995); *Isaly Klondike Co. v. Sunstate Diary & Food Prods. Co. (In re Sunstate Dairy & Food Prods. Co.)*, 145 B.R. 341, 345 (Bankr. M.D. Fla. 1992); *In re Roberts Hardware Co.*, 103 B.R. 396, 398 (Bankr. N.D.N.Y. 1988); *Am. Saw & Mfg. Co. v. Bosler Supply Group (In re Bosler Supply Group)*, 74 B.R. 250, 253 (N.D. Ill. 1987); *W. Farmers Ass'n v. Ciba Geiqa (In re W. Farmers Ass'n)*, 6 B.R. 432, 436 (Bankr. W.D. Wash. 1980).

While the interpretation of the "subject to" language in 2-702(C) of the Uniform Commercial Code has gained widespread acceptance, there is a split of authority over whether a reclaiming seller whose rights are subordinate to the interest of a secured creditor is automatically entitled to an administrative expense priority or a replacement lien equal to the full value of the claim. Some courts have found where reclamation is denied, the plain language of § 546(c) entitles the reclaiming seller to an administrative expense priority or lien in the full amount of the reclamation claim, regardless the existence of the

goods or proceeds or whether the secured creditor is over or under-secured. *See Sunstate Dairy & Food Prods. Co.*, 145 B.R. at 345-46; *Bosler Supply Group*, 74 B.R. at 254; *see also Marko Elecs., Inc.*, 145 B.R. at 28-29; *Melvin Liquid Fertilizer Co., Inc.*, 37 B.R. at 590; *Harris Trust & Savs. Bank v. Wathen's Elevators, Inc.* (*In re Wathen's Elevators, Inc.*), 32 B.R. 912, 923 (Bankr. W.D. Ky. 1983).

The position of these courts is not lacking in textual support. The plain language of § 546(c) states that "the court may deny reclamation to a seller with such a right of reclamation . . . only if the court grants the claim of such a seller priority as a claim of a kind specified in section 503(b) of this title or secures such claim by a lien." 11 U.S.C. § 546(c). As previously stated, even when a secured creditor possesses an interest in all of a debtor's inventory, the reclaiming seller still has "a right of reclamation." *Id.* While the seller's right of reclamation is "subject to" or junior to the prior claim of the secured creditor, the seller's right of reclamation still exists. OHIO REV. CODE ANN. § 1302.76(C). Accordingly, Vendors argue a seller that has successfully demonstrated a right to reclamation under federal and state law is entitled to either an administrative priority or a replacement lien even if the prior secured creditor is under-secured or the goods subject to the reclamation demand are sold in satisfaction of the secured creditor's claim. Vendors argue that under the plain language of § 546(c) the existence of proceeds or the actual disposition of the goods after the petition date is not relevant.

The problem with this interpretation of § 546(c) is that it is contrary to the expressed intentions of the legislature. The legislative history behind the

enactment of § 546(c) reflects Congress' intention to "recognize, in part, the validity of section 2-702 of the Uniform Commercial Code . . . ." H.R. REP. NO. 95-595, at 372 (1977); S. REP. NO. 95-989, at 86-87 (1978). Vendors' interpretation of § 546(c) would give reclaiming sellers something they do not have under § 2-702 of the Uniform Commercial Code – a priority interest in the buyer's assets other than the goods to be reclaimed. *Pester Ref. Co.*, 964 F.2d at 847 (citing *Dixie Enters., Inc.*, 22 B.R. at 860); *Steinberg's, Inc.*, 226 B.R. at 12; *see also Sandoz Pharms. Corp. v. Blinn Wholesale Drug Co., Inc.* (*In re Blinn Wholesale Drug Co., Inc.*), 164 B.R. 440, 447 (Bankr. E.D.N.Y. 1994); *Toshiba Am., Inc. v. Video King of Ill., Inc.* (*In re Video King of Ill., Inc.*), 100 B.R. 1008, 1016 (Bankr. N.D. Ill. 1989). Absent congressional action, it would be inappropriate to analyze Vendors' interests differently simply because Debtors are involved in bankruptcy proceedings. *See Butner United States*, 440 U.S. 48, 55 (1979).

Under the Uniform Commercial Code, if an under-secured creditor forecloses on the goods to be reclaimed and uses the entire proceeds to pay down its secured debt, the seller's reclamation right is rendered valueless. *Arlco, Inc.*, 239 B.R. at 273 (*citing Pester Ref. Co.*, 964 F.2d at 847); *Victory Mkts., Inc.*, 212 B.R. at 743 ("If the seller's right to reclaim is worthless because the superior secured creditor's claim exceeds the value of the goods, the seller's request to reclaim is not denied by the court but rather is of no value, and therefore the remedies of an administrative priority claim or lien under Code § 546(c) are unavailable to the seller."); *Blinn Wholesale Drug Co., Inc.*, 164 B.R. at 448 ("If the seller cannot credibly show that its right of reclamation is other than valueless, reclamation

may be denied and the seller may be granted a secured or administrative priority claim of nominal or no value" (footnote omitted).); *Video King of Ill., Inc.*, 100 B.R. at 1017 ("If . . . the reclamation rights of [Vendors] would be valueless outside of bankruptcy because the goods in question for whatever reason would go first to satisfy the Bank's claim, those rights are equally valueless in the bankruptcy context, and the claimants would be entitled to no administrative claim or lien for the denial of the chance to exercise this valueless right.").

Even if the buyer of the subject goods had additional assets, the reclaiming seller would have no priority interest with respect to such additional assets. The legislative history and the plain language of § 546(c) do not suggest that Congress intended to expand the state law rights of reclaiming sellers at the expense of unsecured creditors in bankruptcy. Rather, the legislative history reflects Congress' intention to recognize the validity of the state law rights of reclaiming sellers. The right to an administrative priority or a replacement lien under § 546(c) is in lieu of, and not in addition to, a seller's right to reclaim. *See Collingwood Grain, Inc. v. Coast Trading Co., Inc. (In re Coast Trading Co., Inc.)*, 744 F.2d 686, 692 (9th Cir. 1984).

Accordingly, this Court rejects the position that where reclamation is denied, the reclamation seller is automatically entitled to an administrative priority claim or a replacement lien in the full amount of the reclamation claim. While the mere presence of a secured creditor with superior rights under § 2-702(C) does not extinguish the rights of a reclaiming seller, consideration must nevertheless be given to the

secured creditor's interest in determining the value of the rights of a reclaiming seller. In priority terms, the reclaiming seller stands behind the insolvent buyer's secured creditors who have security interests in the goods subject to reclamation demands. Accordingly, if the buyer's secured creditor releases its security interest in the goods to be reclaimed, the seller may enforce its right to reclaim. In the bankruptcy context, the secured creditor's decision determines the value of the seller's right to reclaim. *Pester Ref. Co.*, 964 F.2d at 847.

In the case sub judice, the secured creditor's decisions are favorable to Vendors. Pre-Petition Lenders were paid in full through the Interim and Final DIP Orders from the DIP Facility and not from the sale of the subject goods. On the petition date Pre-Petition Lenders were over-secured. Under the Interim and Final DIP Orders, Debtors were authorized to, and did in fact, repay all obligations owed to Pre-Petition Lenders. Upon receipt of these funds any liens granted in favor of Pre-Petition Lenders securing the pre-petition obligations were released. The Court rejects Debtors' claim that the pre-petition liens were preserved to DIP Lenders. The Interim and Final DIP Orders did not transfer the pre-petition liens that secured the obligations arising under the Pre-Petition Credit Agreement from Pre-Petition Lenders to the lenders under the DIP Facility.[7] Rather, the Interim and Final DIP Orders

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[7] This fact distinguishes this case from this Court's prior order confirming non-priority status of reclamation claims in the Wheeling-Pittsburgh bankruptcy. *In re Pittsburgh-Canfield Corp.*, Case No. 00-43394 (Bankr. N.D. Ohio March 13, 2003).

gave Debtors the authority to grant DIP Lenders new liens, and gave DIP Lenders a super-priority claim. Since Pre-Petition Lenders' liens were released, Vendors' right to reclaim is not affected by the interests of Pre-Petition Lenders.

Debtors maintain that all of the goods that were subject to Vendors' Reclamation Demands were sold during the "going-out-of-business" sales, and the proceeds thereof were applied to repay Debtors' obligations under the DIP Facility. No action on the part of a debtor should be permitted to defeat a seller's right to reclamation. *Griffin Retreading Co. v. Oliver Rubber Co.* (*In re Griffin Retreading Co.*), 795 F.2d 676, 679 (8th Cir. 1986) (citing *W. Farmers Ass'n*, 6 B.R. at 432); *see also McLouth Steel Prod. Corp.*, 213 B.R. at 989-90; *Video King Of Ill., Inc.*, 100 B.R. at 1014. A debtor's decision to grant a security interest in inventory to a subsequent secured lender cannot defeat a seller's reclamation rights if the seller asserted its rights before the security interest is granted. Moreover, the Interim and Final DIP Orders explicitly prohibit Debtors from returning the goods constituting collateral under § 546(c) of the Bankruptcy Code. Therefore, having notice of the Reclamation Demands, DIP Lenders cannot qualify as good faith purchasers under § 2-702(C).

CONCLUSION

Debtors seek to relegate to unsecured status the claims of numerous Vendors that have asserted valid reclamation claims pursuant to § 546(c) of the Bankruptcy Code and § 2-702 of the Uniform Commercial Code. Having complied with these statutory provisions, these Vendors had reclamation

claims that were subject to and not extinguished by the prior security interest of Pre-Petition Lenders. When a seller's right of reclamation is subject to the interest of a prior secured creditor, the value of that seller's claim depends on the actual disposition of the subject goods. Pre-Petition Lenders chose to release their security interests and were paid in full through the Interim and Final DIP Orders by the DIP Facility. Thus, the value of the Vendors' reclamation claims is not affected by the interests of Pre-Petition Lenders.

DIP Lenders were granted new liens and super-priority status. They did not assume the liens that secured the obligations arising under the pre-petition loans. Even if the goods that were subject to the Vendors' Reclamation Demands were sold and the proceeds thereof were applied to the DIP Facility, a debtor's decision to grant a security interest in inventory to a subsequent secured lender cannot defeat a seller's reclamation rights. Vendors properly asserted valid Reclamation Demands in accordance with state law, the Code and this Court's Reclamation Procedures Order. This Court rejects Debtors' contention that Vendors' reclamation claims have been rendered worthless and are not entitled to priority. Accordingly, this Court does not find it necessary to address the additional arguments presented by Vendors as to why Debtors' motion should be overruled at this time. For the reasons stated herein, Debtors' motion for entry of an order determining reclamation claims to be general unsecured claims and objection to allowance of such claims as entitled to priority is overruled.

An appropriate order shall enter.

/s/William T. Bodoh
WILLIAM T. BODOH
UNITED STATES BANKRUPTCY JUDGE

UNITED STATES BANKRUPTCY COURT
NORTHERN DISTRICT OF OHIO

JOINTLY ADMINISTERED

No. 01-44007

[Filed November 12, 2003]

IN RE:	)
	)
PHAR-MOR, INC., *et al.*,	)
Debtors.	)
	)

ORDER

For the reasons set forth in this Court's memorandum opinion entered this date, the motion of Phar-Mor, Inc. and affiliated debtors for entry of an order determining reclamation claims to be general unsecured claims and objection to allowance of such claims as entitled to priority is overruled.

IT IS SO ORDERED.

/s/William T. Bodoh
WILLIAM T. BODOH
UNITED STATES BANKRUPTCY JUDGE

APPENDIX F

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Nos. 05-4525/4526

[Filed October 30, 2008]

PHAR-MOR, INC.,	)
Plaintiff-Appellant,	)
v.	)
	)
MCKESSON CORPORATION,	)
Defendant-Appellee.	)
	)

ORDER

BEFORE: BATCHELDER, Circuit Judge; and BUNNING,* District Judge.

The court having received a petition for rehearing en banc, and the petition having been circulated not only to the original panel members but also to all other active** judges of this court, and no judge of this court having requested a vote on the suggestion for

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* Hon. David L. Bunning, United States District Judge for the Eastern District of Kentucky, sitting by designation.

** Judge Moore recused herself from participation in this ruling.

rehearing en banc, the petition for rehearing has been referred to the original panel.

The panel has further reviewed the petition for rehearing and concludes that the issues raised in the petition were fully considered upon the original submission and decision of the cases. Accordingly, the petition is denied.

ENTERED BY ORDER OF THE COURT

/s/ Leonard Green

Leonard Green
Clerk

APPENDIX G

Ohio Revised Code
Title XIII. Commercial Transactions
Chapter 1302. Sales
Remedies

Ohio Rev. Code § 1302.76 Seller's remedies on discovery of buyer's insolvency

(A) Where the seller discovers the buyer to be insolvent he may refuse delivery except for cash including payment for all goods theretofore delivered under the contract, and stop delivery under section 1302.79 of the Revised Code.

(B) Where the seller discovers that the buyer has received goods on credit while insolvent he may reclaim the goods upon demand made within ten days after the receipt, but if misrepresentation of solvency has been made to the particular seller in writing within three months before delivery the ten day limitation does not apply. Except as provided in this division the seller may not base a right to reclaim goods on the buyer's fraudulent or innocent misrepresentation of solvency or of intent to pay.

(C) The seller's right to reclaim under division (B) of this section is subject to the rights of a buyer in ordinary course or other good faith purchaser or lien creditor under section 1302.44 of the Revised Code. Successful reclamation of goods excludes all other remedies with respect to them.

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(2)

No. 08-938

In The
Supreme Court of the United States

PHAR-MOR, INC.,

Petitioner,

v.

MCKESSON CORPORATION,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Sixth Circuit

BRIEF IN OPPOSITION

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COUNTER-STATEMENT OF QUESTIONS PRESENTED

In its Petition for Writ of Certiorari (Petition), the Debtor Phar-Mor, Inc. (Debtor) identifies an issue under the Uniform Commercial Code (UCC) regarding the supposed priority of secured creditors over reclaiming sellers as to reclaimed goods and, in so doing, makes almost no mention of the then operative and dispositive section of the Bankruptcy Code, 11 U.S.C. § 546(c)(2) (1998) (amended in 2005 by Pub. L. 109-8 § 1227(a)). Respondent, McKesson Corporation (McKesson) strongly disagrees with the issue framed by the Debtor. McKesson also disagrees with the Debtor's claim that this matter has "exceptional importance." This is particularly true here where the operative and dispositive bankruptcy statute was substantially amended in 2005 and, concurrently, a new statute was enacted that now governs the core issues raised by this case.

The actual issues before the Bankruptcy Court and the ones which were affirmed by the Sixth Circuit are as follows:

> Whether the Bankruptcy Court properly denied the Debtor's request to reclassify McKesson's reclamation claim from an administrative claim to a general unsecured claim, and whether the Bankruptcy Court properly applied the statutory language of former 11 U.S.C. § 546(c)(2) in awarding McKesson an administrative claim for the $8.6 million of goods that McKesson delivered

COUNTER-STATEMENT OF QUESTIONS PRESENTED – Continued

on the eve of the Debtor's bankruptcy filing and then sought to reclaim.

In addition to these issues, there remains an unresolved issue which was not addressed by the Sixth Circuit or either of the two lower courts:

Whether, in the absence of a secured creditor, the Debtor has standing to assert rights of secured party under § 2-702 of the UCC.

But it is unnecessary to resolve this issue because the Debtor's Petition should be denied.

CORPORATE DISCLOSURE STATEMENT

Respondent is McKesson Corporation, a publicly traded corporation under the market symbol MCK. There are no parent corporations or publicly held companies owning 10% or more of Respondent's stock.

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OTHER AUTHORITIES

STATEMENT OF THE CASE

In September 2001, on the eve of a Chapter 11 filing, petitioner Phar-Mor, Inc. (Debtor) purchased over $18 million dollars in goods on credit from McKesson and 140 other vendors. It did so with full knowledge that it intended to file bankruptcy days later. These pre-bankruptcy purchases were not typical; they were fraudulent. Both the Uniform Commercial Code (UCC) and the Bankruptcy Code contain provisions to protect vendors from this kind of fraud. UCC § 2-702 allows defrauded vendors the right to reclaim their goods, while former 11 U.S.C. § 546(c)(2) required that reclaimed goods either be returned or the reclaiming seller be granted an administrative claim or a replacement lien.

In this case, the Bankruptcy Court did exactly what was required by statute: It awarded McKesson, as a defrauded reclaiming seller, an administrative claim for the value of its reclaimed goods. Then, one and a half years later, the Bankruptcy Court denied the Debtor's request to reclassify McKesson's administrative claim as a general unsecured claim (Reclassification Motion). Both the District Court for the Northern District of Ohio and the Sixth Court affirmed that decision.

In a brazen attempt to generate interest in Supreme Court review, the Debtor proclaims that the Sixth Circuit's decision, among other dire consequences, will have a "devastating impact upon secured loan transactions." The Debtor also contends

that the decision "strips" asset based lenders of their "priority interest in inventory collateral." No evidence supports these hyperbolic statements. In fact the evidence is the contrary. As evidenced by the recent rash of large corporate bankruptcy cases, many of which involve some of this nation's largest retailers, asset based lenders have maintained their security interests in all of their collateral, including inventory legitimately acquired, and lending to these types of companies has not been disrupted.

The issues raised in this case have not arisen in these more recent bankruptcy cases (filed since July 2008). This is due, in part, to the fact that the operative statute in this case no longer exists. In 2005, substantial amendments were made to 11 U.S.C. § 546(c) and 11 U.S.C. § 503(b)(9) was enacted. The end result of those amendments is that any seller that delivers goods to a debtor within 20 days of bankruptcy is automatically entitled to an administrative claim.

In arguing for Supreme Court review, the Debtor also disregards the Sixth Circuit's analytical framework, which rests on the application of the plain text of 11 U.S.C. § 546(c)(2) (1998) (amended in 2005 by Pub. L. 109-8 § 1227(a)). Indeed, the Petition contains only two brief mentions of this statute. The Debtor hopes that by ignoring the operative bankruptcy statute and then proclaiming the Sixth Circuit's decision as having a "devastating" impact on asset based lending and businesses, it can convince this Court to grant *certiorari*. The Sixth Circuit correctly

applied the plain text of § 546(c)(2) of the Bankruptcy Code, as well as its existing precedents. The Sixth Circuit's decision represents a mere reaffirmation of decades of precedent, both under pre-UCC common law and under the UCC, regarding the relative rights of defrauded, reclaiming sellers vis-à-vis debtors and secured creditors. There is nothing remarkable about this decision which would warrant Supreme Court review.

RESPONSE TO STATEMENT OF FACTS

The Debtor's factual recitation contains three materially misleading or omitted facts. Those facts further justify denial of the Petition.

The Debtor states that, at the outset of its bankruptcy case, its pre-petition lenders increased the amount of the secured loan by $35 million in debtor in possession financing (DIP Financing). The truth, however, is quite different and perhaps is best summarized by United States District Judge Boyko, in his affirmation of the Bankruptcy Court's order denying the Reclassification Motion.

> Referencing [the] Final DIP Order, Judge Bodoh found that the Pre-Petition debt was fully satisfied and that there was no transfer or assignment of any lien or security interest to the DIP Lenders. . . . Judge Bodoh found that the Pre-Petition Lenders elected to release their security interests and were paid in full, and that their security interests were

> not assigned or preserved. . . . [McKesson's] [r]eclamation claim . . . deserved to be granted an administrative priority pursuant to United States Bankruptcy Code § 546(c).

Appendix B, page 18a.

The Debtor frequently speaks of secured lenders and how their rights will be impacted in this and perhaps other cases. Yet, the Debtor fails to mention that there are no longer any secured lenders in this case. The DIP Lenders were paid in full in 2002. This is another key fact that supports denial of the Petition.[1]

Lastly, the Debtor fails to mention that in addition to paying the DIP Lenders in full, the Debtor received over $155 million in revenue. Much of the revenue was generated from, or ascribed to, inventory which the Debtor fraudulently procured from sellers on the eve of bankruptcy.

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[1] Throughout this litigation, McKesson has disputed the Debtor's standing to assert the rights of non-existent secured creditors. Undeterred, the Debtor argues in its Petition that the decision deprives secured creditors of their supposed senior security interest in inventory. While the Sixth Circuit (and the lower courts) did not address this standing issue, it remains valid and provides an independent basis upon which the Petition must be denied.

REASONS EXIST WHY THE PETITION MUST BE DENIED

A. The Sixth Circuit Properly Applied the Plain Text of § 546(c)(2) and Existing Circuit Precedent.

The Petition makes it appear that the only relevant statute at issue is § 2-702(C) of the Ohio UCC and this appeal somehow involves a lien priority dispute between McKesson and the Debtor's DIP Lenders. That is not the case. The only issue on appeal was whether the Bankruptcy Court properly denied the Reclassification Motion and, correspondingly, properly granted McKesson an administrative claim after the Debtor refused to return the reclaimed goods to McKesson.

The pertinent Bankruptcy Code section (now amended) is 11 U.S.C. § 546(c). That statute provided, in part:

> § 546. Limitations on avoiding powers
>
> * * *
>
> (c) Except as provided in subsection (d) of this section, the rights and powers of a trustee under sections 544(a), 545, 547, and 549 of this title are subject to any statutory or common-law right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, but –

> (1) such a seller may not reclaim any such goods unless such seller demands in writing reclamation of such goods before ten days after receipt of such goods by the debtor; and
>
> (2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court –
>
> (A) grants the claim of such a seller priority as a claim of a kind specified in section 503(b) of this title; or
>
> (B) secures such claim by a lien.

The Sixth Circuit held that, under the plain text of § 546(c)(2), McKesson was properly granted an administrative claim on account of its unfulfilled reclamation demand.

> It appears clear from the plain language of this statute that McKesson had the *right* to reclaim the goods delivered to Phar-Mor. *See id.* at § 1302.76(B). This finding – that McKesson had a right to reclaim the goods – would seem to answer the pending question and end our analysis; the court, having denied reclamation, was indeed obligated to grant McKesson a priority on its claim, which it did by granting the administrative-expense priority in the amount of the goods.

Phar-Mor, Inc. v. McKesson Corp., 534 F.2d 502, 505 (6th Cir. 2008); App. 7a-8a.

Correspondingly, the Sixth Circuit rejected Phar-Mor's contention that the DIP Lenders' security interest defeated McKesson's entitlement to an administrative claim under 11 U.S.C. § 546(c)(2). In so doing, the Sixth Circuit adopted a similar analysis to that employed by the Bankruptcy Court when it denied the Reclassification Motion:

> Debtors maintain that all of the goods that were subject to Vendors' Reclamation Demands were sold during the [case], and the proceeds thereof were applied to repay Debtors' obligations under the DIP Facility. No action on the part of a debtor should be permitted to defeat a seller's right to reclamation. [citations omitted.] A debtor's decision to grant a security interest in inventory to a *subsequent* secured lender cannot defeat a seller's reclamation rights if the seller asserted its rights before the security interest is granted. Moreover, the Interim and Final DIP Orders explicitly prohibit Debtors from returning the goods constituting collateral under § 546(c) of the Bankruptcy Code. Therefore, having notice of the Reclamation Demands, DIP Lenders cannot qualify as good faith purchasers under § 2-702(3).

In re Phar-Mor, Inc., 301 B.R. 482, 497 (Bankr. N.D. Ohio 2003); App. 64a.

B. The DIP Lenders Were Not "Good Faith Purchasers."

Key to the Petition is the repeated declaration that the DIP Lenders were good faith purchasers and that all secured creditors qualify as "good faith purchasers" and enjoy the protections of UCC § 2-702(C). Yet, the Debtor blithely ignores the actual facts of the case, as found by the Bankruptcy Court, and twice affirmed by the reviewing courts.

At an evidentiary hearing, McKesson proved that the DIP Lenders knew of the reclamation demand before they made the DIP loan and, as a result, did not qualify as "good faith purchasers" under UCC § 2-702(C). The Bankruptcy Court agreed and found that the DIP Lenders were not good faith purchasers. *Phar-Mor, Inc.*, 301 B.R. at 497; App. 64a. The Sixth Circuit agreed that DIP Lenders were not good faith purchasers. It did so based upon similar analysis to that employed by the lower courts.

The Sixth Circuit properly reached this conclusion based on the facts of this case. Neither the Bankruptcy Code nor the UCC defines the term "good faith purchaser."[2] However, the Sixth Circuit properly applied the prevailing definition for good faith purchaser in bankruptcy and non-bankruptcy cases: "one

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[2] The UCC does define, independently, the terms "good faith" and "purchaser." But the term "good faith purchaser" has three distinct words which, when combined, have a well-established meaning.

who purchases the assets for value, in good faith, and without notice of adverse claims." *In re Made in Detroit, Inc.*, 414 F.3d 576, 581 (6th Cir. 2005); *Willemain v. Kivitz* (*In re Willemain*), 764 F.2d 1019, 1023 (4th Cir. 1985) (defining "good faith purchaser" as "one who purchases the assets for value, in good faith, and without notice of adverse claims"); *Greylock Glen Corp. v. Community Sav. Bank*, 656 F.2d 1, 4 (1st Cir. 1981) (same). Here, as the Bankruptcy Court determined, the DIP Lenders had prior knowledge of McKesson's reclamation demand prior to making the DIP loan and thus did not qualify as "good faith purchasers" with respect to McKesson's reclaimed goods. For these reasons, every reviewing court has concluded that the DIP Lenders were not good faith purchasers and, as a result, there was no basis to deprive McKesson of its administrative claim, even assuming that was permissible under 11 U.S.C. § 546(c)(2). Without even the possibility of an actual "good faith purchaser," the Debtor has no legitimate grounds to seek further appellate review of this factual issue.

C. There is No Circuit Split Which Warrants Further Appellate Review.

In an attempt to convince further appellate review, the Debtor argues that the Sixth Circuit's decision is in conflict with the Fifth Circuit's decision in *Stowers v. Mahon* (*In re Samuels & Co.*), 526 F.2d 1238 (5th Cir. 1976), *cert. denied*, 429 U.S. 834 (1976). There is no inter-circuit conflict.

Samuels was a pre-Bankruptcy Code case involving a priority dispute over sale proceeds between the seller of cattle and a debtor's secured creditor. As between those two parties, the Fifth Circuit (over a vigorous dissent) ruled that the sale proceeds belonged to the secured creditor.

In contrast, the present case did not involve a priority dispute between McKesson and the DIP Lenders. The Debtor's DIP Lenders were paid in full during the course of the bankruptcy case. Rather, this case involved the question as to whether McKesson, as a reclaiming seller was entitled to an administrative claim in the Debtor's bankruptcy case under 11 U.S.C. § 546(c) when the Debtor used McKesson's reclaimed goods in the bankruptcy case.

Moreover, unlike *Samuels*, the Bankruptcy Court here conducted an evidentiary hearing on whether the Debtor's lenders qualified as good faith purchasers under § 2-702(C) of the UCC. Based upon language in the then operative DIP loan documents, McKesson established that the Debtor's DIP Lenders knew of the reclamation claims and did not qualify as good faith purchasers. The Debtor, on the other hand, failed to present any evidence to refute this fact. Based upon the evidence presented, the Bankruptcy Court agreed with McKesson and specifically ruled that the DIP Lenders were not good faith purchasers. This fact further distinguishes this case from *Samuels*.

In the 30 years since the Bankruptcy Code was enacted and prior to the Sixth Circuit's decision here,

only one other Circuit directly addressed the prior version of 11 U.S.C. § 546(c) and the issue of a reclaiming seller's entitlement to an administrative claim under that statute. The Eighth Circuit specifically upheld the reclaiming seller's entitlement to an administrative claim, when the reclaimed goods are consumed or disposed of during the course of the bankruptcy case. *See Griffin Retreading Co. v. Oliver Rubber Co.* (*In re Griffin Retreading Co.*), 795 F.2d 676 (8th Cir. 1986). As the *Griffin* court aptly noted:

> In this case the right to reclaim was meaningless since Griffin sold the goods thus removing them from the corpus of the bankrupt's assets. The only logical solution would have been to grant the administrative expense under § 546(c)(2)(A) or secure such claim by a lien under § 546(c)(2)(B). . . . The granting of an administrative claim under § 546(c)(2)(A) is not inconsistent with the right to reclaim, but supplements that right. It provides additional protection to a seller who has delivered goods to a bankrupt debtor on the eve of the bankruptcy. It provides flexibility to the bankrupt estate by permitting the use of the property, if needed for the successful completion of the plan of reorganization. In such case the seller is protected without placing the plan in jeopardy.
>
> This court need not address the interest of the secured creditor [ ]. The conflicting interest of a secured creditor vis-à-vis the rights of the reclaiming creditor, and the question

> of whether a creditor holding a valid security interest in the debtor's inventory is a good faith purchaser or lien creditor . . . , must await the day when the conflict between such competing interests is ripe for determination. [S]ince this action is not one between the competing interests of the reclaiming creditor and the secured creditor, but rather involves the narrower issue of the appropriateness of granting the alternative remedies under 11 U.S.C. § 546(c)(2)(A) or (B), such cases are not dispositive.

Id. at 679-80.

The Sixth Circuit's decision affirming McKesson's administrative claim was consistent with its prior decisions in *In re Mel Golde Shoes*, 403 F.2d 658 (6th Cir. 1968) and *In re Federal's, Inc.*, 553 F.2d 509 (6th Cir. 1977) and the Eighth Circuit decision in *Griffin Retreading*.

In its Petition, the Debtor relies on five main bankruptcy court decisions to support stripping McKesson of its $8.6 million administrative claim. The Sixth Circuit correctly found that those cases, and several others, ignored years of Circuit Court precedent protecting the rights of reclaiming sellers, disregarded the plain language of 11 U.S.C.

§ 546(c)(2), and were not practical, in that they eviscerated the remedy of reclamation.[3]

For example, as noted by the Sixth Circuit, the Sixth Circuit Bankruptcy Appellate Panel in *In re Pittsburgh-Canfield Corp.*, 309 B.R. 277 (BAP 6th Cir. 2004) completely overlooked the Sixth Circuit's decisions in *Mel Golde Shoes* and *Federal's*. The Sixth Circuit also correctly noted that the *Pittsburgh-Canfield* court failed to understand that a reclaiming seller's priority rights cannot be dependant on the post-petition conduct of a debtor, such as consensually encumbering assets in favor of a DIP lender.

The Debtor asserts that all of the reported cases are uniform and support the conclusion that "the right of reclamation is subject to the rights of secured creditors" and therefore McKesson is not entitled to an administrative claim under 11 U.S.C. § 546(c) (1998). This is not true. Numerous cases, including

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[3] The Debtor attempts to make much of the fact that several of the bankruptcy decisions that the Sixth Circuit rejected were issued by two judges in the Southern District of New York, who by happenstance of bankruptcy venue rules and the tactical decision of debtors to bypass their home forums, preside over large bankruptcy cases. Merely because these judges handle large bankruptcy cases does not validate the flawed legal analysis contained in their decisions. To the contrary, Congress' 2005 amendment to § 546(c) and the inclusion of § 503(b)(9), through which any seller of goods on credit within 20 days of bankruptcy automatically receives an administrative claim, evidences Congressional repudiation of these judges' aberrant decisions.

the Eighth Circuit's decision in *Griffin*, hold otherwise. *See e.g.*, *Griffin Retreading Co.*, 795 F.2d at 680; *In re Diversified Food Serv. Distrib. Inc.*, 130 B.R. 427 (Bankr. S.D.N.Y. 1991); *In re Sunstate Dairy & Food Prods. Co.* 145 B.R. 341 (Bankr. M.D. Fla. 1992); *In re Bosler Supply Group*, 74 B.R. 250 (N.D. Ill. 1987).

In *In re Georgetown Steel Co., LLC*, 318 B.R. 340 (Bankr. D.S.C. 2004), a bankruptcy court reviewed and then rejected the holdings in cases such as *Pittsburgh-Canfield*; *In re Dairy Mart Convenience Stores, Inc.*, 302 B.R. 128 (Bankr. S.D.N.Y. 2003); *In re Bridge Information Systems, Inc.*, 288 B.R. 133 (Bankr. E.D. Mo. 2001); and *In re Arlco, Inc.*, 302 B.R. 128 (Bankr. S.D.N.Y. 1999). Faced with a factual situation almost identical to this case, the *Georgetown* court correctly noted:

> Rather than presuming that a senior secured creditor would always assert its rights in a reclaiming creditor's goods as the valuation cases seem to do, in this case no senior secured creditor objected to the relief sought . . . and at the time of the sale of Debtor's assets, including inventory, excess funds remained for distribution . . . [I]n the matter before the Court, the issue no longer involves the competing interests of the secured creditors and the Reclamation Creditors. . . . [T]he Court sees no reason to deviate from the language of § 546(c). . . . Based upon the language of the statute, . . . , the Reclamation Creditors should be entitled to that which § 546(c)(2) provides.

Id. at 348, 351. The *Georgetown* decision, like the others cited by McKesson, provides further support that the Sixth Circuit's decision to affirm was well grounded in law.

D. The Sixth Circuit's Decision Has Not Had and Will Not Have a "Devastating" Impact on Secured Lending.

The Debtor states that the Sixth Circuit's decision has resulted in a "sea of uncertainty" throughout the lending and business communities and predicts that lenders will be unwilling to make asset-backed loans. Those statements have no basis in reality.

Large commercial enterprises have filed and continue to file for bankruptcy throughout the United States since the Sixth Circuit's decision. Some of the larger retail bankruptcy cases include *Circuit City Stores* (E.D. Va.; 11/10/08); *Mervyn's* (D. Del.; 7/29/08); *KB Toys* (D. Del.; 12/11/08); *Boscov's* (D. Del.; 8/24/08); *Fortunoff Holdings* (S.D.N.Y.; 2/5/09); *Value City Department Stores* (D. Del.; 10/26/08); and *Gottschalks, Inc.* (D. Del.; 1/14/09). In each of these cases and many others, multiple reclamation claims have been asserted, while at the same time lenders continue to provide DIP financing. A simple review of the docket from any of these cases confirms that asset based financing, including DIP financing, is as vibrant as ever, even while sellers continue to assert reclamation claims and their rights under 11 U.S.C. § 503(b)(9) and the current version of 11 U.S.C. § 546(c).

In the aftermath of the Sixth Circuit's decision here, legal commentators are in general agreement that the *Phar-Mor* decision was correctly decided. *See e.g.*, *Vendor Whose Reclamation Claim Is Trumped by DIP Lender's Superpriority*, 2008 Comm. Fin. News. 64. One legal commentator even praised the Sixth Circuit for restoring reclamation as a viable remedy in bankruptcy cases to defrauded sellers, following recent years in which a select few bankruptcy judges disregarded the plain text of 11 U.S.C. § 546(c) and § 2-702 of the UCC and the rights of defrauded sellers, such as McKesson. *See Sixth Circuit's Phar-Mor Decision Breathes New Life Into Reclamation Remedy*, Sept. 2008 Am. Bankr. Inst. J. 14. These articles refute the Debtor's hyperbolic assertions that the Sixth Circuit's decision is "devastating" and a "disaster" and has resulted in a "vast amount of debate."

Asset based lenders routinely exclude certain collateral from their borrowing bases, whether it is aged receivables or ineligible inventory. In this case, the Sixth Circuit correctly concluded that when a seller reclaims goods, the debtor/purchaser lacks title to those goods and the reclaiming seller's interest in those goods is superior to all types of secured creditors. Just as a secured creditor has no right to claim a superior interest in stolen goods which happen to be in the possession of a debtor, a secured creditor has no right to claim a superior interest vis-à-vis a reclaiming seller in goods that were obtained by a debtor through fraud (by concealing the imminent

bankruptcy filing from the seller) if that seller properly asserts a reclamation claim to recover its goods.

E. The Debtor Lacks Standing to Assert Secured Creditor Rights under Section 2-702(C) of the UCC When No Such Secured Creditor Exists.

The core of the Debtor's Petition involves a transparent attempt to assert rights of its former secured creditors under § 2-702(C) of the UCC. This attempt is improper. That section provides that the seller's right to reclaim goods is "subject to" a good faith purchaser, which in this case the Debtor contends is the paid-off lenders. Under the text of § 2-702(C), it is a good faith purchaser (assuming, *arguendo*, that the lenders qualified as good faith purchasers, which for the reasons explained above they do not) and not a buyer/debtor who has the right to assert priority over reclamation rights under certain circumstances. Simply put, the Debtor does not have standing to avail itself of the protections afforded good faith purchasers under § 2-702(C). The policy – of protecting a secured lender that qualifies as a good faith purchaser – underlying that statute does not exist here when the DIP Lenders were paid off in full and have no claim to the remaining surplus. This point was recognized by the Eighth Circuit in *Griffin*, 795 F.2d 676, 680.

In *Hartford Underwriters Ins. Co. v. Union Planters Bank* (*In re Henhouse*), this Court addressed the issue of whether a third party may assert rights

conferred on another party by statute. *Henhouse*, 530 U.S. 1, 7 (2000). In that decision, a party other than the trustee sought to assert the right of surcharge under 11 U.S.C. § 506(c). This Court found that this statute had to be read with exclusivity and, therefore, since the statute stated that a "trustee" could assert a surcharge, that only a "trustee" to the exclusion of all others could assert such a claim. Had Congress intended for any other party to assert a surcharge, the statute would have so stated. *Henhouse*, 530 U.S. at 7.

Similar to the reasoning in *Henhouse*, only a good faith purchaser has standing to utilize § 2-702(C) of the UCC. Had the enactors of Article 2 of the UCC intended to allow buyers/debtors to step into the shoes of satisfied secured creditors (in their alleged capacity as good faith purchasers), they would have written the statute that way. They did not. As a result, because no secured party exists, the Debtor cannot utilize UCC § 2-702(C) to defeat the statutory protections of 11 U.S.C. § 546(c) (1998) afforded McKesson and the other reclaiming sellers.

For this reason, the Debtor lacks standing under UCC § 2-702(C) and the Petition must be denied.

CONCLUSION

The Sixth Circuit's decision affirming McKesson's administrative claim was well reasoned and based upon the applicable statutes, existing precedent and the facts. In particular, the Debtor's DIP Lenders were not good faith purchasers, a factual finding that completely undermines the overriding argument set forth in the Petition. There is no reason to review the Sixth Circuit's decision and the Petition must be denied.

Respectfully submitted,

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No. 08-938

In The
Supreme Court of the United States

PHAR-MOR, INC.,
Petitioner,

v.

McKESSON CORPORATION,
Respondent.

On Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

PETITIONER'S REPLY BRIEF

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REPLY TO BRIEF IN OPPOSITION

In the Petition before this Court, the Petitioner seeks review of a recent, and controversial, interpretation of the Uniform Commercial Code by the Sixth Circuit Court of Appeals. Specifically, the Petition presents a pure question of law with significant consequences to commercial lending transactions both in and out of bankruptcy proceedings. The underlying purpose behind the States' adoption of the "Uniform" Commercial Code was to provide both clarity and certainty to business transactions involving interstate commerce, and the Sixth Circuit opinion undermines the stability and predictability required in the commercial lending system.

Respondent's Brief in Opposition is devoted to shifting this Court's attention away from this fundamental question of law. Respondent attempts to accomplish this goal through an unsubstantiated claim, previously disregarded by the reviewing courts below, that the Petitioner lacks standing to challenge the validity and priority of the subject proof-of-claim under § 2-702(C) of the Uniform Commercial Code. In addition, Respondent mischaracterizes the impact of Bankruptcy Code § 546(c) upon the decision of the Sixth Circuit, vis-a-vis its assertion that the decision is premised upon an application of the plain text of that Bankruptcy Code provision. In reality, neither of these arguments are credible and each lacks any meaningful basis in law or fact.

I. The Petitioner Has Standing To Object To Respondent's Proof-of- Claim.

Respondent asserts that the Petitioner has no standing to challenge its asserted proof-of-claim. This argument is nothing more than a "red herring" which the Respondent has unsuccessfully raised in the courts below in an attempt to preclude review of the merits of the substantive legal issue.

In the reclamation procedures order entered by the bankruptcy court in this case on January 2, 2002, the bankruptcy court stated unequivocally that the order granted the debtor [Petitioner] the right to assert "further proceedings to determine the extent to which the reclamation claim amounts are subject to further defenses by reason of liens granted to the Debtor's secured lenders." Thus, the bankruptcy court's order explicitly and unequivocally preserved the secured creditor defense to the debtor's bankruptcy estate.

In addition, the standing argument asserted by the Respondent in this matter has been rejected by other courts in cases under substantially similar facts. *See, In re Dana Corp.*, 367 B.R. 409, 421 (Bankr. S.D. N.Y. 2007) ("the Reclamation Claimants were not lulled by the Debtors into believing that they would receive administrative claims for their reclamation demands. . . the Reclamation Procedures Motion and Order both reference the possibility that reclamation claims may be subject to prior liens."); and *In re Pittsburgh-Canfield Corp.*, 309 B.R. 277, 290 (6th Cir. BAP 2004) (rejecting estoppel argument and noting that the reclamation procedures order referenced the bank liens as defenses to the reclamation demands).

The Respondent's assertion regarding Petitioner's lack of standing is inconsistent with the bankruptcy court's January 2, 2002 reclamation procedures order and applicable case law, and therefore should be rejected by this Court.

II. In Its Decision, the Sixth Circuit Stated That Because it Was Addressing a Specific Issue of Law under the Uniform Commercial Code, the Bankruptcy Court's Factual Findings Were "Immaterial".

Respondent would lead this Court to believe that the Sixth Circuit's decision was based upon the application of the plain text of § 546(c) of the Bankruptcy Code. To the contrary, the Sixth Circuit's interpretation of §2-702 of the Uniform Commercial Code was the underlying foundation of the decision. The Sixth Circuit specifically opined that, "[w]e find that Ohio Rev. Code § 1302.76(B) (UCC 2-702(2)) grants a properly reclaiming vendor. . . a right to reclaim its goods and that § 1302.76(C) (UCC 2-702(3)) does not allow a secured creditor's claim to defeat that right." (Pet. App. Page 13a.).

In addition, the Sixth Circuit specifically stated that, "[t]his case presents a question of law or an application of the law to the given circumstances, and the bankruptcy court's factual findings are immaterial to the disposition of this appeal." (Pet. App. Page 49).

Thus, the Sixth Circuit's interpretation of the Uniform Commercial Code was in no way reliant upon the Bankruptcy Code or the factual findings of the bankruptcy court. The Circuit's decision, which is in conflict with decisions of the various courts of other

circuits, is clearly applicable and equally damaging outside of a bankruptcy proceeding.

Finally, Respondent's assertion that the Sixth Circuit's decision in this case has no application in bankruptcy cases filed after October 2005 is inconsistent with the language of the current version of § 546(c) of the Bankruptcy Code. The amendment to § 546(c) became effective in October 2005 and provides, in pertinent part, that a reclamation claim "is subject to the prior rights of a holder of a security interest in such goods".

In its opinion, the Sixth Circuit held that a bank cannot assert a security interest in goods that are the subject of a reclamation claim because the bank does not qualify as a good faith purchaser under § 2-702 of the Uniform Commercial Code. If the reclamation goods are not subject to a bank's security interest, the reclamation claimant will continue to have a superior claim, despite the bank's prior UCC lien filings. Therefore, the Sixth Circuit decision will continue to have application in current and future bankruptcy cases.

CONCLUSION

For the reasons provided herein and in the Petition for Writ of Certiorari, the Petition should be granted. It is time to settle the debate on this crucial issue of commercial law.

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